HOW SHALL BUSINESS BE TAXED?

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FOREWORD

The subject of business taxation is in an unsettled state, theoretically as well as politically. There is no consensus among tax authorities concerning how business should be taxed, as there is, for example, in connection with personal taxation. The underlying theory of business taxation is still in dispute. Economists have not agreed whether a system of business taxation should be based on the principle of benefits received or ability to pay.

There is even greater uncertainty concerning how either of these two principles could be most satisfactorily realized in taxing business. Moreover, the nature of business enterprise is in the process of changing markedly, and general understanding concerning the social and economic implications of the change is hazy. As business changes, the methods of taxing it will also change. Present methods—federal, state and local—leave much to be desired. The process of experimentation will no doubt continue until some reasonably satisfactory system is evolved. What lines this evolution will take it is impossible to say.

It was believed that the Tax Policy League would render a valuable public service by bringing together in a national symposium persons who had given thoughtful consideration to the problem of business taxation. Plans for such a conference were accordingly made by the program committee consisting of the following members: Thomas H. Reed, Chairman, Kossuth M. Williamson and Herbert D. Simpson, and *ex officio* Harold S. Buttenheim and Mabel L. Walker.

The program committee with the benefit of suggestions received from the Advisory Council of the League, made a

selection of those topics which seemed most important for discussion at the present time. Because of the limited number of sessions which could be held it seemed impracticable to attempt to include in this program consideration of franchises and licenses, sales taxes of various kinds, property taxes which fall upon business, and the taxation of specific types of enterprise such as chain stores, utilities, banks, insurance companies and others.

The underlying theory of business taxation was given special consideration. In addition there were sessions devoted to a discussion of taxes which fall upon business generally, such as income taxes and the recently enacted undistributed profits and social security taxes.

Outstanding students of taxation from the fields of business, administration, and economics were selected as speakers.

The spontaneous and protracted discussion from the floor which followed at the end of each session evidenced the lively interest of the audience in the papers presented. The conviction of the committee concerning the unsettled state of the theory of business taxation was more than justified by these discussions. It became evident that not only was there lacking a consensus among economists concerning whether business taxes should be based on the benefits received or the ability to pay principle, but there was also no general agreement as to what constituted taxpaying ability on the part of a corporation, and whether indeed a corporation could be said to possess such "ability" at all, in the generally accepted sense of that term. Unfortunately, it has not been possible to incorporate this discussion in the present volume. A committee of economists is being formed by the Tax Policy League to give further thought to clarifying some of these problems of terminology.

The Tax Policy League believes that the thoughtful papers presented herein will prove stimulating and helpful to persons seriously concerned with the problems of busi-

ness taxation. The publication of this volume carries with it, of course, no endorsement of the theories—sometimes conflicting—of the various authors.

We express our sincere gratitude to the contributors for their generous aid in the conduct of the symposium, and to the members of the program committee for their services in planning the program and selecting the speakers. Appreciation is also expressed to numerous members of the Advisory Council who contributed valuable suggestions for the program.

MABEL L. WALKER,
Executive Secretary,
Tax Policy League

New York City
March, 1937

CHAPTER I

WHAT IS BUSINESS AND WHAT ARE BUSINESS TAXES?

KOSSUTH M. WILLIAMSON

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BUSINESS is a term of many definitions. This catholicity of meaning has led one writer to conclude that it is "impossible to compile a reasonably compact group of generalizations to cover the manifold senses in which the term is used in the literature of the social sciences."[1] Certainly the term has several meanings in the field of taxation with which we are concerned. In taxation, of course, it has reference to a separate and independent object of taxation as distinguished from other objects such as property or persons. In this respect, however, the term seems to be used in at least two senses important for our purposes: (1) to mean business entities as distinguished from the natural persons concerned in them; and (2) to denote a group of economic activities or occupations of different types, constituting the callings of men by reason of which the entities engaged in them are taxed.

When the term refers to entities, it includes all of the forms of business organization—corporations, partnerships, or sole proprietorships. A tax upon a "business" may thus mean a tax upon any one of these entities. Or a tax upon a particular type of enterprise would touch all entities engaged in it. Similarly, a tax upon all businesses in this sense

[1] Dexter M. Keezer, "Business," *Encylcopedia of the Social Sciences,* Vol. 3, pp. 80–81.

of the term would mean a tax applicable not only to corporations but to other entities as well. Thus, when we speak of a "general business tax," we may mean that it is general in that it embraces unincorporated as well as incorporated businesses. It is, therefore, an elementary observation that the limitation of many of our business taxes to corporations grows out of policy rather than out of definition of business.

When the term refers to types of activity, we have the problem of determining what occupations are embraced within the scope of its meaning. As the term is understood in this sense, it includes most of the economic activities or types of occupation. In fact, the term is so broad that for tax purposes it requires interpretation and limitation. For example, the Supreme Court of the United States, quoting the legal dictionaries,[2] has said:[3] "'Business' is a very comprehensive term and embraces everything about which a person can be employed" and again business is "that which occupies the time, attention, and labor of men for the purpose of a livelihood or profit.'"[4]

Since "business" as a term is so inclusive, the question naturally arises how broad is business to be considered for purposes of business taxation or of a general business tax. The answer that has been given for the latter purpose by the first Model Tax Committee of the National Tax Association is found in the definition of business contained in the draft of a Model Business Tax Bill prepared under its auspices. Business is there defined to include "trade, profession, occupation or employment."[5] Even this definition is a bit vague because of its very inclusiveness. The diffi-

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[2] See *Corpus Juris*, Section on "Business."
[3] *Flint v. Stone Trace Co.*, 220 U. S. 171.
[4] *Ibid.*
[5] *Bulletin of the National Tax Association*, January, 1921, p. 113. See also J. J. Klein, *Federal Income Tax*, 1929, p. 492 for the definition of business for purposes of the income tax given by the United States Treasury Department.

culties with such language, if made the basis of a general business tax, would probably be associated with the border line cases, the outer fringe of occupations. We may say at least that there is probably a debatable zone of activities, the inclusion of which within the concept of business would depend upon legislative policy and administrative regulation. Doubtless, in any strict interpretation of business, salary and wage work, purely investment activities, and probably the activities of artists and non-employing craftsmen should be excluded.

If, however, we follow the meaning of business in the broadest sense in which it may be properly understood, it is clear that it includes more than manufacturing and mercantile pursuits as it is sometimes understood,[6] or than manufacturing, mercantile, commercial and amusement enterprises which it is made to mean by some because of the exclusion of public utilities, banks, insurance companies and the like which involve special problems.[7] It also includes much more than activities carried on under corporate form. In business taxation, therefore, we may say that business, when used to mean activities, may be understood to include manufacturing; wholesaling, retailing, and other mercantile and commercial activities, including agencies, and commission and brokerage businesses; public utilities; banking; insurance; amusement and other service enterprises; professions; and other occupations.

It should be noted, however, that so far none of our several business tax systems, separately considered, including the Southern license tax systems, and the combined corporation and supplementary unincorporated business taxes of Connecticut and New York, embrace all of the activities included within the meaning of business in its broadest

[6] R. A. Girard, *The Scope for Uniformity in State Tax Systems*, Special Report of the New York Tax Commission, p. 131.

[7] National Industrial Conference Board, *State and Local Taxation of Business Corporations*, p. 4.

sense. It should be noted also that these remarks are concerned only with the meaning of business and carry no implications as to the proper policy as to the scope of business taxation, a question which lies outside of the province of this paper.[8]

Defining Business Taxes

Let us turn now to the question of what are "business taxes." Here, too, we have terms which may be used in many senses. When we speak of business taxes we may have reference to the several methods of taxation relating to special types of business enterprise as when we treat of taxation of public utilities, taxation of banks, or taxation of manufacturing. In such cases, we have in mind all of the taxes collected from the businesses comprising a particular category of enterprise, and involving the total tax burden upon the members of that industrial group. We may also mean, by business taxes, the taxes collected from any business entities as distinct from taxes collected from natural persons. Business taxes in this sense would comprise all taxes paid by business no matter what their nature or type, even though applicable to natural persons as well as the business entities.

"Business taxes," as you are aware, have, however, a third and more technical meaning. The term, in this more technical sense, refers to a separate category of taxes as distinguished from other taxes collected from business. We, thus, differentiate between taxes paid by business and "business taxes." It is with the classification of "business taxes" in this sense of a separate category that we are concerned

[8] The question of what constitutes "engaging in" or "doing" an activity, understood as a business in the meaning of that term, has not been considered here because of the limitations of space. This is an important question, however, which deserves more attention than it has received in the literature of taxation. See, for comments on the significance of "doing" business with particular reference to the sales taxes, Haig and Shoup, *The Sales Tax in the American States*, 1934, pp. 552–559.

here. In the subsequent remarks as to classification of business taxes, the legal nomenclature will be disregarded. Such legal names as franchise taxes, privilege taxes, excise taxes, occupation taxes and the like may obscure rather than reveal the real nature of the taxes to which they are applied.

Among the taxes collected from business but not falling within the category of business taxes are the taxes paid by businesses upon their property. Probably the ad valorem taxes on public utilities, and the gross receipts taxes imposed in lieu of property taxes are also to be considered as "non-business" taxes in the sense understood here. It is important to point out, however, that such taxes, when they place upon businesses discriminatory burdens heavier than property taxes, may contain an element of special business taxation in the sense of an additional burden not otherwise borne under the general property tax.[9] Thus, when the "in lieu" feature does not involve relative equivalence, such taxes may be hybrids of property and business taxes.

There is another "in lieu" tax of a different variety which also probably should not be treated as a business tax in the true sense. The tax referred to is that on corporation income, which is made an integral part of the personal income tax, being considered in lieu of the personal tax on dividends exempted in the hands of stockholders. Such so-called corporation income taxes, though collected from or through business entities, should, strictly viewed, be considered as methods of taxing persons.[10] These "in lieu" corporation income taxes are, therefore, not here classified as business taxes, although it is recognized that they may, perhaps in a different sense, be regarded as business taxes.[11]

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[9] This seems to be the inference of the second Committee on a Model Plan of State and Local Taxation of the National Tax Association, hereafter referred to as the second Model Tax Committee. See its Report, *Proceedings of the National Tax Association*, 1933, pp. 386–387.

[10] *Ibid.*, pp. 366, 399.

[11] Carl Shoup, "Business Taxes," *Encyclopedia of the Social Sciences*, Vol. 3, p. 122.

The remaining taxes collected from business may then be considered "business taxes" in the sense in which that term is understood in this paper. Business taxes, in this sense, are taxes collected from business entities as such as distinguished from taxes collected from persons only or as distinguished from taxes on property paid by both persons and businesses. Such business taxes are additional to property taxes paid by businesses and additional to other taxes paid by the owners as natural persons. Business taxes are, thus, impersonal or objective,[12] being imposed upon the business entities as taxpayers without reference to the personal economic status of the owners. Such are the criteria of differentiation, the earmarks, so to speak, of business taxes as distinctive elements of the family of taxes. Business taxes, thus conceived, constitute a large category of heterogeneous taxes.

This broad category of business taxes may be divided into three more or less distinct subclasses. If we may borrow a biological term, we may say business taxes are a genus of taxes, comprising three species. In the first class we may place the special taxes upon certain businesses and the special and general corporation taxes. These taxes would include capital stock taxes, and probably corporate excess taxes,[13] gross receipts taxes not in lieu of nor substituted for property taxes, special taxes upon insurance companies, including premium taxes, bank share taxes[14] and other bank

[12] This term "impersonal" or "objective" seems sufficient for our purposes to indicate the criterion of absence of consideration of personal status of the natural persons involved in differentiating business taxes. See, however, the more elaborate classification of business and occupation taxes into "semi-personal" and "demi-personal" and of taxes on commodities and on transactions as "impersonal" made for the purpose of the special problem of double taxation, by Professor Seligman, in his *Double Taxation and International Fiscal Cooperation,* 1928, p. 84.

[13] The nature and classification status of corporate excess taxes is discussed below.

[14] The bank share taxes because of the special congressional limitations on taxation of banks are legally considered as taxes upon stockholders collected by the banks, but in reality these levies on shares perform the function today of business taxes, like other capital stock taxes.

taxes in addition to levies on real estate and property of banks, and corporation net income taxes when additional to personal income taxes on dividends, or when unaccompanied by personal income taxes at all, and certain chain store taxes, excess profits taxes, and others.

In the second group of business taxes would go a considerable group of taxes which are generally otherwise classified than as business taxes. Among these are the general sales taxes, selective sales taxes, commodity taxes, customs duties, stamp taxes on business documents, transaction taxes such as those upon deals upon stock and produce exchanges[15] and the new payroll taxes upon employers. Such taxes qualify as business taxes in that they are, as a general rule, collected from business men and rest upon the volume, movement, and transactions of business.

In the third class would go the business taxes, in the more restricted sense of the term, meaning single all-embracing taxes, covering all business as we have defined business above. We do not have in this country as yet an example of a business tax so completely inclusive as this such as exists in Europe. The closest approximations to it are found in the Southern license tax systems and in the combined corporation taxes and unincorporated business taxes of Connecticut and New York. Strictly speaking, however, even these taxes, falling short of the all-embracing type and in no case being uniform, should be classified in the first class as business taxes in the broader sense. The list of taxes mentioned in these three classes is not intended to be exhaustive but to illustrate the various types of business taxes.

It is obvious that the term, business tax, may be used in a broad or narrow sense. In the above remarks I have followed the practice of some other writers[16] by using it in both senses. I have thus included within the meaning of

[15] Cf. Shoup, *op. cit.*, p. 122.
[16] Particularly Shoup, *ibid.*

business tax in the broadest sense the large group of taxes associated primarily with business and possessing sufficient characteristics in common to distinguish them as a category from other taxes collected from business. The use of the term in this broader sense seems to be justified for, in the absence of a better term, it serves to designate these several taxes on business which for certain purposes need to be considered together.

This broadening of the meaning of business taxes, however, raises some questions as to the bases and validity of such a wide category of classification. It involves, of course, treating as business taxes certain taxes which have been traditionally regarded merely as corporation taxes. If, however, the movement grows of adopting separate unincorporated business taxes as coordinate parts of the business tax systems, it will be unrealistic not to regard as business taxes the corporation taxes which will form integral parts of the pattern of the systems then existing.

The broadening of the meaning also entails overlapping or double classifications of taxes. By this is meant that it necessitates classifying as business taxes certain levies which may be otherwise classified. Instances of such taxes are the commodity taxes, transaction taxes, selective sales taxes, and general sales taxes falling in the second class mentioned above. For example, a customs duty collected from a natural person importing a dutiable article might be regarded as a personal tax or a direct tax[17] but if collected from an importing business firm would, in the wider sense, be regarded as a business tax. If in the latter case the duty is shifted, however, it may be classified also as a consumption tax in effect. Or take the case of selective sales taxes or even of a gasoline tax.

A gasoline tax by reason of its imposition upon distributors for collection may be regarded as a business tax for the

[17] E. R. A. Seligman, *Double Taxation and International Fiscal Cooperation*, p. 68.

distributors, especially if not passed on to consumers. When such taxes are passed on to purchasing businesses, using the commodities in business, they may be regarded as business taxes for such business users of the articles. When such taxes are passed on by the original taxpaying distributors to personal consumers, we may regard such taxes as consumption taxes and so classify them by reference to their supposed incidence. Thus taxes designated as business taxes in one sense may be placed in a different category with reference to other criteria of classification. Some of these so-called business taxes may lead, as it were, a double life in our classifications being regarded as personal taxes, commodity taxes, consumption taxes or business taxes depending on the conditions and on how we look at them.

Sales Taxes as Business Taxes

Consider also the case of the general sales tax. This tax may be classified separately or be classified as a consumption tax. It is very often classified in the latter category along with other commodity taxes.[18] On the other hand, it is also treated by some as a form of business tax as is done in this paper.[19] The justification for regarding a turnover tax as a business tax is, of course, stronger than in the case of other sales and commodity taxes because it possesses all of the earmarks of a business tax in the narrowest sense—collection from business entities, impersonality of imposition, and all-embracing application.

It is, of course, recognized that a sales tax may be passed on by business men to consumers, although we know that the incidence turns on many factors and our knowledge of

[18] See, for example, the Report of the second Model Tax Committee, *Proceedings of the National Tax Association*, 1933, pp. 410–416.

[19] See Carl Shoup, *op. cit.*, p. 122. Lutz, also, in his *Public Finance*, 1936, p. 631, includes the sales tax in a group of taxes, which he says are "in the main" to be considered as "also methods of taxing business." I interpret this to mean that he regards the sales tax as a "business tax" in the sense understood here.

the actual effects of such taxes is limited. The point we wish to make is, as we have already indicated, that the shifting of the tax and its possible classification as a consumption tax need not destroy the validity of its classification also as a business tax. Otherwise, we are in difficulty in the classification of other business taxes which are levied on the basis of various so-called external indicia and which may likewise be shifted to consumers or to production factors involved in the businesses taxed.

If we exclude one such tax from the category of business taxes because of shifting, to be consistent, we would have to exclude all shifted business taxes, so far as classification goes. Especially is this true of a gross receipts tax either in the form of a separate business tax for a particular business, or of a minimum tax as an integral part of a more general business net income tax.[20] If classification is to turn upon incidence, and if gross receipts taxes prove to be shifted, these levies though generally regarded as business taxes would have to be omitted from that category along with supposedly shifted sales taxes. Nor can the distinction between gross receipts taxes and sales taxes, suggested by some,[21] be justified on the basis of legislative intent that sales taxes be shifted and of the mandatory provisions for shifting included in some of the sales tax laws. This distinction breaks down if, in actual operation, the sales taxes are not shifted despite the statutory provisions.

This illustrates the fundamental difficulty, even if it seemed advisable, of basing the classification of business taxes, on their incidence. The effort to classify business taxes with precision by reference to incidence would encounter the familiar difficulties involved in the traditional dichotomy of taxes into direct and indirect. Whatever the

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[20] As recommended by the second Model Tax Committee, *Proceedings of the National Tax Association*, 1933, p. 398.

[21] Lutz, *op. cit.*, p. 597, uses language which implies this distinction.

feasibility of determining the incidence of some business taxes, it does not seem advisable to deny the designation of business tax to taxes upon sales which constitute gross receipts of some businesses and to give that designation to taxes upon gross receipts of other businesses. Especially is this division of the two types of taxes questionable when some of the sales taxes have the title of "business," "business and occupation" and "license" taxes.[22]

Double Classifications

Thus the procedure as to classification suggested here is that for such business taxes as may be deemed to rest upon consumption, when that fact can be known, double classifications be recognized. Taxes such as sales and commodity taxes, classified here as business taxes in the widest sense, would be placed also under the head of consumption taxes when they seemed to be shifted to consumers. Such double classification of taxes might be involved in the case of other taxes also. In fact, in public finance many classifications of the same taxes are conceivable depending upon the purposes of the categories. At any rate to distinguish certain taxes, otherwise classified, as business taxes does not seem to make of the term, business tax, a "misnomer" as it has been called by some.[23]

Attention is called, however, to the difference between the importance of incidence as a criterion of classification and as a factor in the shaping of business taxes. The inclusion of levies within the category of business taxes, without reference to shiftability, for classification purposes is not intended to carry any implications as to the unimportance of considerations of incidence in the development of business tax policy. On the contrary, it is the view of the pres-

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[22] *Tax Systems of the World*, 1935, pp. 136–139.
[23] Cf. Jensen and Howe, *Tax Study in Thirteen Lessons*, Kansas Chamber of Commerce, 1932, No. 9, p. 6.

ent speaker, that recognition of impersonality as an earmark of business taxes should not be taken to mean that it is a matter of no importance as to who are hit by business taxes as is held by some.[24]

Although other factors such as fiscal requirements, stability of revenues, and administrative feasibility deserve consideration in the determination of a business tax program, the distributional purpose or incidence intention of such taxes is not to be lost sight of. Professor Haig, among others, has rightly stressed the fact that the distributional purpose is of crucial importance in the shaping of business tax policy. With reference to the distributional purpose of business taxes, the latter has posed these questions: "Should our business taxes be designed to be shifted or should they be designed to be borne by the business itself? Should they be considered as charges payable by all as a condition precedent to participation in business activities or should they be considered community shares in the profits of those who conduct business activities with success?"[25] I agree with Haig as to the importance of the answers to these questions in the development of satisfactory methods of business taxation. I must, however, leave this matter of distributional purpose to the other speakers.[26] I have mentioned it

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[24] For example, see Ronald B. Welch, *State and Local Taxation of Banks in the United States*, Special Report of the New York State Tax Commission, p. 168. Welch says: "It is *only* in the case of a *business tax* that it is not a matter of particular concern whether the stockholders, or the customers, or both finally shoulder the burden. Presumably both benefit from the conduct of the business and both may justly be called upon to support the activities of the governments which aid in the conduct of the business." (Italics mine)

[25] R. M. Haig, Preface to Carl Shoup, *The Sales Tax in France*, p. vi.

[26] It may be worth while to record here, however, the position of Professor Haig as to what should be the incidence policy. He has said: "A true business tax may be defined as one which, for the greater part at least, rests as a burden upon the owners of the business and thus is not passed on to consumers in the form of higher prices." Report of the New York State Commission for the Revision of the Tax Laws, 1932, p. 181.

Professor T. S. Adams, too, once said of a business tax: "It is logically essential that the business man (not the consumer) should pay." "Fundamental Problems of Federal Income Taxation," *Quarterly Journal of Economics*, August, 1921, p. 552.

only to avoid any misconstruction of my classification of business taxes without reference to incidence.

The broadening of the meaning of business taxes presents also some difficulties as to whether certain other taxes associated with business are to be classified as business taxes. The "corporate excess" tax is an example. This tax as it exists in most states is, strictly viewed, doubtless to be treated as a property tax. In Massachusetts, however, it forms a coordinate part of the corporation excise of that state.[27] Thus perhaps a distinction must be made between the Massachusetts tax and that of other states by the inclusion of the former in the category of a business tax broadly considered. Perhaps also there may be some justification for treating the elements of the ad valorem and "in lieu" gross receipts taxes on public utilities, representing discriminatory burden, as true business taxes.[28] It is very difficult, however, without painstaking study to estimate this business tax element in such taxes. Caution must also be used in classification of severance taxes since Professor Lutz has found that some levies classified by others as severance taxes are no more than fees or adaptations of the general property tax.[29]

So far in this country, no generally agreed upon classification of existing taxes to be regarded as business taxes has been worked out. Incidentally, this gap should be filled, if it is feasible to do so. Perhaps the suggestions which I have offered as to the taxes to be placed in the business tax category will not be completely accepted. There may be those who will not agree to the use of the term business

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[27] See, for a discussion of this tax, Lutz, *Public Finance*, 1936, p. 591. Cf. also Barnet Hodes, *Essays in Illinois Taxation*, pp. 58–61, for the legal nature and status of the Illinois corporate excess tax.

[28] The second Model Tax Committee, at any rate, recommends, in case of the adoption of its suggested general business tax, some reduction of such taxes or some relief from the general business tax. *Proceedings of the National Tax Association*, 1933, p. 386.

[29] Lutz, *op. cit.*, p. 654.

tax in the wider sense employed here. However that may be, it will undoubtedly be agreed that the subject of business taxation is very comprehensive. The recognition of this fact accounts for the note at the end of the program.[30] There it is explained that the limitations of the program do not permit consideration of many taxes classified as business taxes, much less of other taxes collected from business. My remarks will at any rate indicate something of the scope of business taxation and will make it clear that omissions of important taxes from the program are made because of limitations of time and not because they are considered as outside of the purview of the subject.

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[30] This note read: Because of the limited number of sessions which can be held it has been impossible to include in this program consideration of franchises and licenses, sales taxes of various kinds, property taxes which fall upon business, and the taxation of specific types of enterprise such as chain stores, utilities, banks, insurance companies and others.

CHAPTER II

THE ATTITUDE OF BUSINESS CONCERNING BUSINESS TAXATION

NOEL SARGENT

Secretary, National Association of Manufacturers

THE general viewpoint of American industry with reference to business taxation is set forth in the following statement adopted at the recent annual meeting of the National Association of Manufacturers and the Congress of American Industry:

> "Government very properly should take through taxation from the income of production, as from other sources, such portion as is necessary to perform economically the constitutional functions imposed upon it."

The problems immediately raised by this principle may be set forth as follows:

1. What are the legitimate functions of government, considered from both the economic and constitutional aspects?
2. What can be done to secure economic and efficient administration of government?
3. What kind of taxes should be levied to raise money to permit performance of legitimate governmental functions? In a federal system of government this raises the further question as to the possibility of developing a sound national tax system, of the kind and relationship of national and state taxes.

In these remarks I shall consider only the last of the problems—namely the business viewpoint as to the kind of taxes which should be levied. This problem itself is so broad that available time obviously permits only a brief conspectus of the subject.

But before considering the nature and justification of specific taxes, there are two points to be borne in mind—

(1) The subsequent criticism of specific kinds and features of taxes, many having been developed over a long period of years, is not merely aimed to reduce the volume of taxes; while reduction in taxes is obviously desirable—it is equally important that for the general welfare taxes levied should be both sound in principle and fair in application. In other words, the form of tax may not only be as harmful but in many cases more harmful than the particular burden involved.

(2) In considering the burden or ultimate incidence of taxes upon industry, the nature of industry as such is frequently entirely overlooked. Approximately 95 per cent of manufacturing is done by corporations. It is estimated that there are approximately 11,000,000 separate industrial stockholders in the United States, and we can not logically consider taxes upon the earnings or profits of corporations without considering their relation to the investment and earnings of these stockholders. "Industry" or "business" as such has no taxpaying ability; the taxpaying ability which exists is in reality the ability of the stockholders in industry.

Tax Principles

With reference to the formulation of industrial views on specific tax problems, it is obvious that industry must have a basis for analysis. The following six tax maxims which have been adopted at the 1936 Congress of American Industry supply this basis:

(1) *All taxes, irrespective of their form or the point at which they are originally levied, are ultimately a taking of a portion of income or capital that would otherwise belong to some individual for his own private use.*

(2) *All taxes should be tested to determine if the ultimate burden or incidence is equitably distributed.*

In connection with these maxims reference to public discussion and advocacy of new tax proposals during 1935 and 1936 apparently indicates a belief that all taxes should be based on the so-called "ability to pay" principle—that those with ability to pay more should do so. Analysis, however, indicates that while there might be some justification for having the tax system as a whole based on this principle it is impossible for each specific tax to conform to it. If each tax levied were based on this principle, the government would have no back-log or bulwark of taxes to rely upon for governmental support when the general national income declines and this at the very time when government burdens for relief, or other emergency purposes, may be increased. Tariffs, real estate taxes and internal revenue taxes on beer, wine, liquor and tobacco are examples of generally accepted taxes not based on the ability to pay principle which provide tax income when the general national income declines, thus furnishing a government back-log or reserve of tax sources for emergency relief—just as the well-managed corporation should have a reserve to rely upon for emergency uses. Where imposition of a relatively inequitable tax is necessary, the inequities may at least be roughly corrected by a proper balancing of the tax system as a whole.

Without considering its part in the whole tax picture, we cannot justly condemn a specific tax standing alone merely because it is not equitable. The burden and fairness of the entire tax system, coupled with its ability to produce necessary revenue, are the paramount consideration.

(3) *Under modern conditions an equitable personal income tax is one of the fairest forms of taxation that has been developed.*

We do not mean to imply that in a well balanced tax system income taxes should be the sole source of revenue. On the contrary, we believe the income tax should be supplemented by a number of different forms of taxation. Nor do we mean to imply that we believe the present federal and state personal income taxes to be either the best or even a suitable embodiment of this maxim. In the application of the maxim there still remains a wide area for difference of opinion as to the degree of progression which should be used; the correct definition of income and the maximum and minimum limitations for practical application of the income tax.

Theoretically we would favor the imposition of income taxes solely upon individual incomes. Income taxes paid by corporations come out of some individual's earnings, (either the stockholder, the consumer, the employee or perhaps all of them), and since that individual may be a person of either large or small income the principle of graduated rates is violated if the corporate income is taxed. The principal argument in favor of corporation income taxation is that it is a convenient form in which to levy and collect taxes.

Assuming, however, that corporate incomes are to be taxed, then we believe that as a practical matter those charged with the responsibility of levying taxes should decide how much should be secured by taxes from business corporations, taking into account the factors of apparent ability to pay, the effect of both the kind and rate of each tax upon the consumers and employees, and the effect upon industrial stockholders—most of whom are persons of small incomes owning few shares of stock. After giving due consideration to these factors all business corporations should be taxed at a flat rate.

Progression or graduation of rates of corporation income taxes, as embodied in the 1935 and 1936 Federal Revenue Acts, is unfair to many individuals of small income and in every walk of life.

The National Tax Association has never rejected the suggestion made to it in 1919 by its Federal Taxation Committee that the Federal Corporation Income Tax should be at a flat rate. No subsequent developments, moreover, afford any sound reason for challenging the following statement approved in 1932 by a House Sub-committee (of the Ways and Means Committee) on Double Taxation:

> "No satisfactory system of applying the graduated rate principle to the net incomes of corporations, has as yet been devised."

(4) *The real burden of taxation is roughly proportional to the percentage which the total tax burden is of the total national income.*

It is submitted that there is a maximum point in the diversion of national income to government purposes, which if exceeded will so disrupt the economic balance that the total national income will decrease, and in the end there will be a complete economic collapse. We doubt if anyone can predict just what that point is, and certainly we do not attempt to predict it, but we believe that among many thoughtful men and women there is a growing apprehension that that point is being rapidly approached, and this apprehension, as it grows, will of itself have a very harmful and depressive effect upon the economic structure of the country.

(5) *Those forms of taxes which fall directly upon the individual, payable by the individual, have the least harmful effects on the national economy and the economic machine.*

Because such a program if carried into effect would bring home to the people the enormous burden of taxation under

which it is now suffering, it will for that reason be unpopular with those who would like to conceal from the people what this enormous tax burden really is.

The average family which pays no income tax today nevertheless, according to recent studies, pays out between 12 per cent and 16 per cent of its annual income in "hidden taxes" unseen in the cost of what it buys. We believe it is of the utmost importance that all those who exercise the right to vote should be conscious of the effect upon themselves of government expenditures; this consciousness can best exist where direct taxes are substituted for indirect taxes which the individual does not realize he is paying. Such direct taxation of the individual has, moreover, another distinct advantage. It tends to relieve the processes of production, upon the smooth functioning of which the largest possible national income is dependent, from the restrictive effect of taxes levied in the first instance upon the various processes of production.

(6) *Taxation should be used exclusively for revenue purposes or as an instrumentality to enforce powers specifically delegated to Congress.*

Application of Tax Principles

In attempting to apply the foregoing tax principles to current tax problems, particularly in the field of Federal taxes, industry's observations and conclusions may be briefly summarized as follows.

It is obvious that in considering the business viewpoint upon current taxes and tax proposals it is impossible to avoid at least slight mention or discussion of subjects which are assigned for full discussion elsewhere on your program. My reference to such subjects can, of course, only be brief and it is hoped may in part at least, contribute to the cumulative review.

Perhaps the foremost Federal tax in everyone's mind today is the undistributed earnings tax. It is not my intention to go into any detail on the theory of this tax, both because the industrial viewpoint was thoroughly presented before the Senate Finance Committee and in the recently adopted report of our Government Finance Committee, and also because you are to have an intensive discussion on this subject tomorrow evening. I do, however, wish to call your attention to two interesting observations on the justification of reserve accumulations by business.

The first is a statement made in July, 1934, by the Department of Labor in a booklet on *Organization and Management of Consumers' Cooperative Associations and Clubs.* It is interesting to note that this government recommendation to cooperative associations declares—

> "Many associations . . . accumulate a reserve fund considerably in excess of their share of capital. Members should be encouraged to be generous to their reserve fund and the future security of their association and not be too anxious to divide among themselves at the end of the year every penny available."

The second statement is a discussion of accumulation of business reserves by the Secretary of Labor in her book *People at Work.*[1] Miss Perkins said that "well managed corporations" have protected "investment against unemployment" and that "no one has ever thought that such continuity of dividend payment was a dole. It was intelligent, and provided regular incomes to investors dependent on this income. . . . Investors were very largely paid out of reserves that had been built up in the past. Nobody suggests that such foresight undermines the initiative and responsibility of the investor. Such plans show what sound,

[1] P. 262.

intelligent management and accounting can do when a problem like stability of investment is deemed important."

While Miss Perkins justifies business reserves as a source for payment of dividends when they are needed to increase purchasing power, it may be pointed out that the Department of Commerce has stated that the major portion of such reserves has been used during the depression years to sustain salaries, wages and interest. In other words the practice of withholding dividend payments in good times in order to permit accumulation of funds for plant expansion, contingency reserves and future dividend payments, actually results in a greater distribution of funds when funds for business and personal expenditures are most needed.

In the opinion of business the 1935 Revenue Act, by establishing a graduated tax upon corporate incomes, taxes larger earnings at a higher rate without regard to the proportion of such earnings to investment, and thus discriminates against business efficiency and success, generally speaking in favor of the small corporation as against the big corporation. The 1936 Revenue Act, establishing a tax on undistributed net earnings, inserts in our tax system exactly the opposite principle. It is a tax which penalizes the small company and the company starting in business by making it more difficult to accumulate reserves for working capital, expansion and emergencies and thus places in a favored position the already established company with adequate financial resources.

Specific Defects of 1936 Revenue Act

We believe in short that taxation of undistributed corporation net earnings as contained in the 1936 Revenue Act is unsound—that it is, as stated by Joseph B. Kennedy, former Chairman of the Securities and Exchange Commission, based "upon a fallacious economic principle." Business agrees with Mr. Kennedy's view, and believes that the

tax can not be rendered economically sound merely by amendments.

In its present form, however, the tax indubitably bears more heavily upon certain groups or types of corporations than upon other corporations. As President Roosevelt said October 21, 1936, if there are "imperfections" then they "must be corrected for the good of American business."

American industry has therefore prepared a list of specific "imperfections" whose correction would, in its opinion, be "for the good of American business." It is not my purpose at this time to attempt to analyze these "imperfections" or suggested amendments in any detail, but among the principal suggested amendments to the undistributed earnings tax and to the Federal Corporation Income Tax provisions are the following—

(*a*) Amend Section 26(c) to provide the same credit now allowed in the case of anti-dividend contracts entered into prior to May 1, 1936, which are renewed upon expiration after that date.

(*b*) Further amendment of Section 26(c) to provide adequate protection in the case of all contracts which legally prevent the payment of dividends. As now worded protection is given only to contracts which deal "expressly" with the payment of dividends. There are, however, many contracts not "expressly" preventing the payment of dividends which actually have that result.

(*c*) Similarly we would suggest amendment to protect corporations which are prevented by state legislation from paying dividends in certain cases. Such state requirements compel the corporation to operate under them in order to have the right of continued existence. They are in essence a part of the basic "contract" between the state and the corporation which it charters, but, as we understand it, are not recognized by the Bureau of Internal Revenue as

contracts which "expressly" prevent the payment of dividends. The result is that a corporation has no protection in many states which have requirements legally preventing dividend payments.

(*d*) Further amendment of Section 26(c) to provide the same credit now allowed in the case of debt payment contracts entered into prior to May 1, 1936 where such contracts are renewed after that date.

(*e*) We also advocate re-establishment of the privilege of making consolidated returns.

The heavy corporation taxes under rates now existing make more advisable and more necessary than ever before from an economic standpoint provision for such consolidated returns, since it is necessary for many large industrial enterprises to organize subsidiaries for special or local business purposes. Consolidated returns were initiated without specific statutory authority by the Commissioner of Internal Revenue in 1917, at a time when the excess profits tax was first in effect. The object of the Commissioner was to get more revenue for the government. In the 1918 act, the Commissioner's procedure was validated and consolidated returns given statutory recognition. This action originated in the Finance Committee of the Senate, which said:

> "While the Committee is convinced that the consolidated return tends to conserve, not to reduce the revenue, the Committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the government."[2]

[2] Senate Report No. 617, 65th Congress, 2nd Session, p. 9; Senate Reports, public, vol. 1.

Inasmuch as the excess profits tax has been re-enacted, a provision for consolidated returns would again be of benefit to the government in some cases.

(*f*) We further suggest amendment of the Federal corporation income tax to provide special allowances in the form of either tax exemptions or decreased tax rates for undistributed earnings which actually exist in accounts receivable or inventory. Frequently such profit is not in reality actual operating profit, does not exist in cash, is not available for distribution in dividends, the payment of debts, or the purchase of additional plant and equipment, although under the present tax law and the regulations for determining income, inventory profits are taxable.

(*g*) We recommend further amendment of the Federal corporation income tax to provide that any taxation of corporate income should allow for taxation of average profits. After analyzing the two principal ways in which this can be done—namely the Norwegian system of taxing average profits by the use of a three-year moving average, and the English system under which a loss suffered by a concern in one year may be written off against profits in subsequent six years—our Government Finance Committee states—

> "While either system has advantages from the standpoint of the taxpayer, we believe that from the standpoint of payments by taxpayers and regularity of receipts by government the Norwegian system of tax based on moving average profits is preferable."

(*h*) We further urge abolition of the Federal taxation of intercorporate dividends. Such taxes are not primarily designed to raise revenue but indirectly to control the form of corporate organization. Granted that the holding company idea has in some instances been abused, yet

it is neither fair nor reasonable to condemn therefore all industrial subsidiary relationships by imposing a penalty tax upon them. Under present business conditions the industrial subsidiary relationship is often a necessary piece of business machinery; such necessary pieces of business machinery can not be destroyed without loss to investors, disruption of the business mechanism, and a brake on industrial production and employment. The indiscriminate taxation of intercorporate dividends directed at so-called "holding companies" detrimentally affects thousands of legitimate industrial subsidiary relationships of an entirely different character.

(*i*) Without attempting to present the details and the reasoning involved, our analysis of the combined Federal excess profits tax and capital stock tax indicates that their combination discriminates against corporations with fluctuating earnings in favor of corporations with steady earnings, a policy which we believe has no reason or justification. We are, therefore, of the opinion that irrespective of the merits or demerits of a true excess profits tax or of a true capital stock tax, that the combination of these two taxes in the manner now provided in the Federal revenue laws, is unjust and discriminatory and should be immediately repealed.

Payroll Taxes

In addition to the undistributed earnings tax the new payroll taxes are of major concern to American industry at the present time. It is obvious that because of the large size of payrolls, using them as a base, a tax of relatively low rates will produce a large amount of revenue. They have heretofore not been taxed in this country. Such taxes are introduced now for the special purpose of raising revenues for social security, that is, old age annuities and unemployment compensation. Without discussing the particular uses

to which it is now proposed to devote the proceeds of payroll taxes, it may be observed that as these taxes become effective the burden on payrolls from these two sources alone will be very heavy and it is submitted that they therefore should not be availed of or considered for any other purpose.

It may be observed moreover that from the standpoint of tax theory the levying of a tax on an article inevitably tends to diminish the extent of its use. This fact should be clearly kept in mind with the levying of any tax; just as a tax on theater admissions tends to increase the cost of tickets and reduce the number of theatergoers, a tax on bank checks to reduce the number of bank checks; a tax on windows to reduce the number of windows; just so a tax on payrolls tends to decrease the volume of employment; it likewise will tend after it becomes operative to retard pay increases as each pay increase will mean a tax increase.

We support the belief of E. R. A. Seligman, that—"The imposition of a tax on wages injures the workman both temporarily and permanently."[3]

Sales Taxes

There is a general impression that those advocating either income or sales taxes must do so from antagonistic viewpoints. It is our belief on the other hand that both income and sales taxes may be combined in a sound taxing system. Specifically, we believe that income taxes and sales taxes together are basically sufficient to supply a majority of the federal revenue needed. The combination of these taxes permits taxation according to ability to pay and also provides a fairly steady source of revenue. It is our belief that sales taxes should be levied by the Federal Government only if the Federal Government at the time levies income taxes.

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[3] *The Shifting and Incidence of Taxation,* 1910 edition, p. 370.

We recommend that the Federal Government should levy a one point manufacturers' sales tax—that is, a tax levied at only one point of manufacture, this being on the last processing involved. The tax should be levied both on domestic manufactured products and also on all competitive imported products, thus avoiding giving the foreign manufacturer any special advantage by reason of the imposition of such sales tax only on American manufactured goods.

A general manufacturers' sales tax is not recommended as an additional tax, but exclusively as a substitute for a variety of present sales taxes. Levied at a moderate rate, however, it would not only replace the revenue from such selective sales taxes but would secure a substantial additional revenue. If any exceptions or exemptions from the tax should be provided they should be limited strictly to food, clothing and medicine.

The present Federal special sales taxes on selected articles should be repealed, with the exceptions of the internal revenue taxes levied on beer, wine, liquor and tobacco. With reference to our present advocacy of elimination of special selective sales taxes now levied by the Federal Government, we observe that the House Ways and Means Committee in its 1932 report declared:

> "As to a tax on certain selected industries . . . such a tax involves unfair discrimination."

We regard the taxes levied on copper, oil, coal and lumber by section 601(c) of the 1936 Revenue Act as tariffs and thus as not coming within the scope of this recommendation.

Federal and State Relations

This brings us immediately to the problem of Federal and state tax relationships. We agree thoroughly with Secretary Morgenthau that—

> "Independent levying of taxes by all of the various taxing authorities, without due consideration for the tax structure as a whole, has often resulted in unfair and uneconomic distribution of the burden."

Available evidence, moreover, indicates that double taxation between the Federal and state governments has been increasing in recent years. The problem involved is complicated by the existence of over 175,000 separate taxing units in the United States. It has been estimated by Professor William Anderson of the Political Science Department of the University of Minnesota that under a rationalized scheme of local government the number of taxing units could be cut to about one tenth the number now in existence. Such reduction coupled with a scientific division of tax revenue would mean a great step forward in the science of government and the creation of a sound Federal-state taxing system.

Division of Tax Sources

We make the following specific suggestions with reference to division of tax sources.

(1) We believe serious consideration should be given by Federal and state tax authorities to abandonment of state income taxes, thus reducing burdens upon the taxpayers and creating greater equality of taxation of all income taxpayers.

If it is deemed inadvisable to eliminate state income taxes then careful consideration should be given the question of whether the Federal or the state government is to have the first "crack" at the income. It is suggested, moreover, that if a state does impose an income tax it should determine its own rates, but these rates should be based as far as possible on the taxable net income as established by Federal income tax returns.

(2) Elimination by the Federal Government of all present Federal selective sales taxes except excise taxes on beer, wine, liquor and tobacco.

(3) Abandonment by the states now levying them of state tobacco taxes.

(4) Abandonment by the states and their political subdivisions of gallonage liquor, wine and beer taxes (leaving to the states and their subdivisions licensing taxes in this field).

(5) Abandonment by the Federal Government to the states of inheritance, estate and gift taxes. Such taxes should be used by the Federal Government only in emergencies.

Business Cycles

We believe, as stated previously, that taxes should be used for revenue purposes or as a means of enforcing powers specifically delegated to Congress. It is entirely consistent with this principle to suggest abandonment or modification of taxes which tend to accentuate periods of both prosperity and depression.

Secretary of Commerce Roper recently stated that vigorous action was needed to prevent a runaway stock market and business boom so that unhealthy economic expansion may be prevented. I agree entirely with the Secretary and suggest that revisions in our Federal tax laws are essential if the purpose Mr. Roper has in mind is to be accomplished.

In the first place, the present form of the undistributed earnings tax will in the opinion of investment bankers tend to reduce the number of provisions for retirement of bond issues through sinking funds. It will thus tend to stimulate unsound distribution of funds which should be used for sinking fund purposes, encourage speculative use of such funds, and create new corporation financial difficulties when earnings decline.

Moreover, the operation of the capital gains and loss tax likewise tends to hold securities off the market, thus decreasing the supply of securities available for sale, artificially increasing the market prices of securities sold, and stimulating financial speculation and over-expansion.

James M. Landis, Chairman of the Securities and Exchange Commission, in addressing the investment bankers recently said that when stock prices have—

> "no relation to earning power, present or prospective, a mechanism that will permit maintenance of values of that character has lost its justification."

The operation of the present capital gains and loss tax definitely encourages the very thing Mr. Landis deplores, namely—the creation of stock prices which have no relation to their present or prospective earning power. This tendency is further aggravated by the existing tax on undistributed earnings which by encouraging distribution of dividends from sums which should be retained for plant expansion or emergency uses exclusively, tends to force up market prices of securities. Industry urges constructive amendments of existing tax laws which would tend to prevent artificial speculation in securities that forces security prices higher in times of prosperity and lower during times of depression.

Tax Commission

Secretary of the Treasury Morgenthau declared August 10, 1936, that the existing situation

> "makes it possible and timely for us now to consider revision of the tax laws."

Mr. Morgenthau said further that it is advisable to review

> "all tax laws in which may be found inequities or features harsh to business . . . there should be a reduction in taxes in some cases."

Industry suggests that consideration should be given not only to the amount of taxes but to the principles of taxes imposed and proposed, and the manner in which they affect the taxpayer, who must continue to have income if the government is to have revenue.

Industry therefore suggests the desirability of appointment of a special Federal commission to study and report to the Congress as to changes, if any, which in its opinion should be made in our present national tax policy. Such a committee, if appointed, should be composed of representatives of the Joint Committee on Internal Revenue Taxation, of the Treasury Department, of finance, of major branches of productive enterprise and independent tax economists.

On behalf of industrial producers, a major group of taxpayers, the National Association of Manufacturers offers full cooperation in the creation and investigation of such a commission to study carefully our present national tax system.

CHAPTER III

EQUITY AND EXPEDIENCY IN BUSINESS TAXATION

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It seems quite futile to discourse at length on economic and financial theories of equity in business taxation without giving attention to another kind of theory which creates most of the difficulties, namely legal theory. The institution which causes us trouble in the field of business taxation is the corporation, and the legal theory which causes us trouble is that the corporation and the stockholder are distinct legal entities. This well established legal theory and rule is the product of no end of confusion.

Difficulties Caused by Legal Theory of Corporation

Many people would prefer to see the income tax applied only to individuals in accordance with their ability to pay. That is, they would not apply the tax to corporations at all. This is the rule in Great Britain where corporations are not taxed except to collect from individuals. This might be quite feasible in both countries were it permissible to tax individuals on their proportionate share in what the corporation makes and does not distribute. Where as at present the individual may not be so taxed, the inequity which arises from exempting the corporation from the tax is apparent. Many people have small need of large amounts of

ready cash and the corporation is a convenient instrument through which they can invest and reinvest their savings. By leaving their earnings with the corporation indefinitely stockholders could virtually escape taxation entirely.

On the theory of two legal entities it appears logical to tax the corporation and the stockholder as though they have no relation to each other just as we tax the income of the merchant and the doctor as two distinct incomes in spite of the fact that one may have contributed to the other. Actually, however, we know that the incorporation of a piece of property does not double the wealth which it represents and that the corporation and the stockholders are in fact very much the same economic entity.

Because of the fact that the taxpayers with the largest incomes now receive most of their incomes through corporations and because individual taxes might formerly have been avoided indefinitely by means of corporate reinvestment of earnings, we now have a Federal tax on undistributed corporate income in addition to the Federal corporate net income tax and the personal tax on cash dividends. It is true that this new tax may drive earnings out of corporations in many instances where it would be better socially for such earnings to remain with the corporation. It is true that in many cases where earnings are not distributed and are subjected to the new tax the result will be an undifferentiated and unfair indirect burden among the ultimate stockholders. And it is true that corporations which for one reason or another are obliged to retain their earnings within the corporation bear an unfair burden as compared with those that are more fortunate and can afford to distribute all they make. Nevertheless, as long as the individual cannot be taxed on what the corporation does not distribute, some tax of this sort is necessary to make the personal income tax effective.

The present Federal patchwork, with some refinements,

may be the nearest approach to equity and expediency that can be made under the present legal rules. A more satisfactory solution waits upon a statutory or constitutional amendment which would make it possible to tax under the personal income tax the increase in individual wealth which results when corporations earn money. Our problem arises from the attempt to apply a personal tax to impersonal institutions.

Were this artificial legal situation dissolved, there would be no problem of double taxation, exemption of stock dividends, reinvested corporate income, and personal holding companies, and the problem of taxing capital gains and deducting capital losses would be much mitigated. On the other hand if we have to start with the proposition that we are irrevocably committed to existing legal rules, then we shall end by admitting that there is no very defensible solution to any of these problems. We are reduced to a choice between lesser and greater evils.

It is true, of course, that to tax stockholders on their share of the undistributed earnings of corporations has both practical and legal difficulties of its own. It may embarrass the stockholder to pay substantial taxes on increments in his wealth which remain with the corporation. But the embarrassment can be easily alleviated by the corporation through a stock dividend which the stockholder may convert into cash or a partial distribution of earnings in a cash dividend. Some administrative difficulty would arise from the fact that every adjustment in corporate net income would involve a corresponding adjustment for all of the corporation's stockholders. But this difficulty should not prove insurmountable.

The legal difficulties of taxing stockholders on their shares of undistributed corporate income are very great. Fortunately the corporate institution is entirely the creature of the state and should not be beyond human control. But

the Supreme Court made it clear in *Eisner v. MacComber*[1] (stock dividend case) that receipts left with the corporation are not realized to the point of income so far as the stockholder is concerned. Possibly an act to require all corporations engaged in interstate commerce to seek a Federal charter might be a way around the legal difficulties. One of the provisions in such a charter could require corporation stockholders to pay taxes like partners in a partnership, that is, whether the corporation distributes any of its earnings or not. The legal difficulties in the alternative here suggested are formidable, but if it represents the way to a simple and equitable solution of the corporation tax problem, the legal difficulties may be worth contending with.

Other Grounds for Taxing Corporations

If it were possible to tax the individual stockholder upon his share of the undistributed corporate income and if this were done, would it still be desirable from the standpoint of equity and social expediency and fiscal expediency to tax corporations as such or business as such? Some grounds would still exist for such a policy. First, it could be argued that the corporation tax affords an easy way to collect revenue at the source and that the tax is a very productive one. This is a fiscal expediency argument. It is entitled to some weight, but it would be much less valid under the assumed condition than now. Of course, there is also a political difficulty in imposing direct personal taxes on the scale which would be required were we to abandon all taxes on business as such. If the personal income tax were given a broad base and could reach undistributed earnings it would yield better than now, but it would be pressed to the limit (as is the case in England) to carry the entire income

[1] *Eisner v. MacComber*, 252 U. S. 169.

tax load. Some contribution from corporations would be a big fiscal help.

It may be argued also with plausibility that whether or not the corporation is recognized as a legal entity, it enjoys certain special benefits which justify special taxes. Among these special benefits not enjoyed by other types of business are sometimes cited limited liability and permanent existence. These privileges, however, are a free good which may be enjoyed by any group which wishes to start a corporation. Just how much value shall we ascribe to a privilege of this kind? Presumably under conditions of free competition it should have no value whatever. This is not to say that the corporate method of doing business has no advantages. It is to say that the advantages, being available to all, cannot be given a monetary value.

Progressive Taxation of Corporations

But there is a reciprocal side of the benefit proposition having to do with the cost to government which corporations entail. In general, corporate business is identified with large business or, perhaps more accurately, large business is identified with corporations. There appears to be some ground for the view that big business imposes a heavy load of responsibilities and problems on government for which the latter might be justified in making some special charge. Among these responsibilities and problems a few can be listed at random:

Indirect supply of the consumer which necessitates protective consumer legislation

Unequal bargaining and impersonal relations with labor which necessitate labor legislation

Monopoly

Concentration of population and of wealth

Unemployment and economic insecurity

If it is true that these problems arise from big business which in turn almost universally takes the corporate form, this will sustain a special tax on corporations. While the correlation between the size of business, the problems created and the amount of net income may not be very perfect it is perhaps sufficiently plausible to sustain some progression in the tax.

If the tax is to be progressive, it would appear reasonable to abandon incorporation as a basis of classification and make size the basis. This is under the assumption of course that the double entity theory is eliminated. Under this assumption incorporation as a basis of classification becomes illogical. Under present rules corporations differ from all other businesses in that they are entities distinct from the people who own them. Hence special classification is warranted.

It can be argued of course, that corporations as such have ability to pay and that such ability may be measured by their net income. In a certain sense, corporations do have faculty or the power to produce the revenue which we call taxes. Ability to pay, however, is mainly a personal idea and cannot be very plausibly associated with a distinctly impersonal institution like a corporation. If we are seeking to gauge ability to pay we can do it best by looking to the stockholders rather than to the corporation. Certainly the mere volume of corporate net income with no regard to capital investment is a poor indication of ability to pay.

It has been held also that business taxes as such are justified on the ground that they afford a method of dividing income tax receipts between the jurisdiction of origin and the jurisdiction of the stockholder's or entrepreneur's personal domicile. Where income tax revenues go to some central government for use by it this problem may be avoided. If the central government collects all income tax revenue and distributes part or all of it to the subdivisions

on some basis including origin as an element the problem might again be avoided. Where smaller units of government such as states or counties are rivals for this source of revenue the problem is a very real one. Taxing the corporation or other business unit at its place of operation may give the debtor or absentee-owned states something to tax under the income tax.

Considerations of Social Expediency

So far we have been speaking purely of considerations of equity and fiscal expediency. There are also considerations of social expediency which need to be considered. These are the non-fiscal or social-control aspects of the problem. It is argued for example, that a graduated business or corporation tax is justified as a tax upon size. This is based upon the proposition that big business is undesirable and that the tax system should be used to discourage it. As we have previously indicated, it can be shown that big business brings a great many problems. But it also brings a great many advantages. And big business may be a necessity in certain lines of production such as steel, where enormous capital is required, and not in others. For these reasons the writer is prone to reject this argument.

But it can be argued that certain corporations at certain times make exorbitant profits and that these exorbitant profits may be due to imperfections in competition, which is supposed to keep profits at a minimum. It cannot be doubted that there is much truth to this contention. The recapture of monopoly profits may be justified on the ground of special benefit or privilege, on the ground of ability to pay, and on the ground of social expediency. Here lies the basis for an excess profits tax.

The argument can be made, of course, that monopoly or near-monopoly profits cannot be distinguished from the

rewards of superior management. Even superior management where it results in a high rate of return for the corporation may, however, indicate some ability to pay if corporations may ever be said to have this attribute.

It may be conceded that the excess profits tax encounters terrific difficulties when any attempt is made to administer it upon a rational basis. The present Federal excess profits tax cannot be regarded as more than an administrative device to help administer the capital stock tax. Or if it is regarded as a member of the Federal tax system in its own right, its basis of administration is so capricious as to deprive it of much virtue. Nevertheless, the profits tax contains so much that is theoretically sound and sensible that it seems that we should not drop it from the tax system without further attempts to find for it a workable system of administration.

Another non-fiscal objective in business taxation remains to be considered, and that is the simplification of the corporate structure. The depression has made us realize more than ever before how exceedingly complicated modern business finance has become. In the past our taxation system has encouraged this development by allowing affiliated groups of corporations to file consolidated returns and by exempting intercorporate dividends from taxation. The result was that the holding company, greatly over-developed institution that it is, paid few or no taxes. At present in our Federal system the privilege of consolidated returns is very much circumscribed; intercorporate dividends must be included in the tax base of the recipient corporation to the extent of 15 per cent of their total. In the writer's opinion, these are sound features of the new Federal law. An entangled and topheavy financial structure is definitely antisocial. The tax system should recognize that fact.

Grounds for Taxing Business under a Different Legal Theory

So far we have been working upon the assumption that our legal problem is eliminated and that the stockholder is to be taxed on his share of the corporation's undistributed earnings. On this basis we have reached the following conclusions:

1. That while much of the ground for business taxation has been removed by our assumption, and it can be granted that business taxation should be relatively less important than is now the case, some ground exists to warrant some business tax.
2. That some weight should be given to the fiscal advantages of retaining the corporation tax.
3. That some factor of progression may be justified on the benefit or cost theory.
4. That the business tax affords the jurisdiction of origin an opportunity to get some revenue from the income tax.
5. That the excess profits tax is warranted as a measure for reaching monopoly profits and taxing the ability to pay of specially fortunate corporations; it must be admitted that administration is exceedingly difficult.
6. That the non-fiscal purpose of encouraging the simplification of business structure justifies certain existing procedures and features in our business income tax law.

Grounds for Taxing Business under Present Legal Theory

If the assumption made above (concerning the taxability of undistributed earnings) is removed, the ground for a business tax and a very substantial one, is reinforced. The taxation of both corporate income and cash dividends is justified particularly in the absence of a tax on undistrib-

uted corporate profits. The former must be taxed to get some revenue from undistributed corporate earnings, the latter to make some differentiation between large and small stockholders. Moreover, if the theory of separate legal entity is to be used by corporations in their own behalf, which is constantly being done, they should not be heard to plead the single entity argument in their own defense.

The tax on undistributed corporate earnings is made quite essential because of the unequal burden imposed directly or indirectly upon the stockholder of the corporation which does and the one which does not declare dividends. It has long been apparent that our tax system has placed a much heavier burden upon distributed corporate dividends than upon undistributed corporate earnings. It has been common practice in this country for corporations to plow profits back into their businesses rather than to declare cash dividends. The Ford Motor Company has grown from a mere shop to one of the largest businesses in the world mainly through this process. If earnings are undistributed the individual stockholder pays no tax at all, unless and until he sells his stock and is assessed on a capital gain. But he may not transfer his stock until he dies, in which case the capital gain would not be taxed at all. (Capital gains as such on property transferred at death are ignored.) Thus taxes on undistributed earnings have been remote and uncertain. Distributed earnings, on the other hand, were immediately subject to high surtaxes.

This system of unbalanced burdens upon distributed and undistributed income was admirably adapted to an economy that needed to encourage business saving and discourage spending. But that economy no longer exists. Our tax system should favor, if anything, the declaring of dividends rather than the reinvesting of corporate earnings.

Thus if we are not to be allowed to tax the stockholder upon the corporation's earnings it appears that a tax on

undistributed corporation earnings, complicated and objectionable in certain respects, as it may be, is a necessary addition to our revenue system.

As stated above, incorporated business is put in a separate class by the double entity theory and while this theory remains effective, corporations must be treated differently from other business.

The further question arises as to whether if there is to be a tax on undistributed earnings there should be a corporate net income tax as well. The answer is that the undistributed earnings tax is not a business tax, but a device for driving income out of corporations' treasuries. The arguments presented above to support a business tax as such would still be valid.

Approaching the problem now solely from the social expediency, or non-fiscal standpoint, what are the interests which need to concern us in business taxation and what kind of a tax policy do they require?

1. *Monopoly.* It is probably impossible and inadvisable to use taxation as a way of preventing monopoly, but it, perhaps, may be used to recapture certain monopoly gains. This is the reason why we should seek to develop a genuine excess profits tax in our tax system.

2. *Redundant savings.* It is widely believed at the present time that the balance between saving and spending unduly favors the former. If there is truth in this plausible contention, it supports a tax on undistributed corporate earnings or other methods of eliminating the tax differential against distributed earnings.

3. *Over-complication of the financial structure.* This, as previously explained, supports present provisions in the federal law regarding consolidated returns, intercorporate dividends and personal holding companies.

4. *Great concentration of wealth.* This supports the efforts which have been made to make the personal income tax

effective, including the tax on undistributed corporate earnings.

5. *Too much speculation.* Taxation cannot prevent speculation nor possibly discourage it very effectively. It can capture some part of speculative gains through the capital gains feature of the Federal law.

The tax program recommended by social expediency does not appear to conflict seriously with that recommended by equity and fiscal expediency.

Summarizing briefly the more important positive conclusions of this paper we might emphasize:

1. That our plan of taxing corporations must remain illogical and unsatisfactory as long as the legal fiction separating the corporation from the stockholder is persisted in. It is recommended, not too hopefully, that the fiction be abandoned.

2. That fiscal expediency, cost of service and division between districts of origin and domicile justify a business tax independent of consideration of the stockholders' ability to pay.

3. That a tax on undistributed corporate earnings is necessary under present legal rules, to make the personal income tax effective.

4. That several considerations—especially those pertaining to monopoly—justify further efforts on behalf of the excess profits tax.

CHAPTER IV

CRITIQUE OF PRESENT METHODS OF BUSINESS TAXATION IN THE UNITED STATES

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In this paper, so far as space permits, an attempt will be made to appraise the various types of business taxation, to examine critically the theories of business taxation in their practical application, to state some of the more pressing problems calling for solution, and to suggest the general direction reforms should take. The problems which will be discussed here are not altogether peculiar to business taxation; indeed, many of them are also present in the collection of other taxes. The complexity of the problems of business taxation should be noted at the outset. In meeting these problems it must be determined: (1) what principles should be recognized, (2) which taxes should be selected to tax business, (3) which businesses should be subject to taxation, (4) how much taxation should be imposed, (5) what rates, exemptions, credits, deductions, and other details should be applied, and (6) in what manner these taxes should be administered.

The problems of business taxation are further complicated by the fact that some of the taxes levied on business are peculiar to business activities, while others are laid on business along with other taxpayers; that some of the taxes paid by business tend to remain with business while other taxes tend to be shifted; that corporations may be separated from incorporated enterprises for particular methods of

taxation; that some taxes are imposed upon business in general while others are adapted to or confined to specific industries or types of business; that the objects upon which the taxes are levied vary; and, finally, that there are numerous jurisdictions imposing business taxes. In the broad sense, there is a great variety of business taxes, there are many taxing governments, and there is much diversity in the methods of levying and collecting these taxes.

The Importance of Business Taxes

Although statistics are not available to indicate the total amount of taxes paid by business or the total collections from each type of business taxation, it is generally recognized that a large portion of the tax payments in the United States is contributed by business. It was estimated a short time ago that 45 per cent of the nation's taxes were levied on property, 25 per cent were imposed on commodities and collected from business, 22 per cent were obtained from special taxes on business and motor vehicles, 6 per cent were derived from the personal income tax, and 2 per cent from death taxes.[1] The above estimate did not, of course, separate the taxes on business property from taxes on other property. It appears to be a safe conclusion that well over half of the nation's taxes are collected from business in the first instance.

The Federal Government in recent years has obtained by far the greater part of its tax revenues from business. In 1930, two-thirds of the total Federal taxes were collected from business, and by 1935, four-fifths of the total Federal taxes were secured from business. The great preponderance of state taxes is also procured from business. In 1934, for example, the states derived over one-half of their total taxes from business, excluding property taxes paid by business.

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[1] See Interstate Commission on Conflicting Taxation, *Conflicting Taxation, the 1935 Progress Report*, p. 104.

The local governments, to be sure, obtain roughly nine-tenths of their tax revenues from imposts on property, but a large part of the property tax receipts come from business.

Trends in Business Taxation

As a background for a discussion of the problems of business taxation, it will be well to refresh our minds concerning the general trends which have developed. Our purpose here will be to consider the various taxes paid by business and not only the taxes that are designated by the laws as business taxes, the taxes that are paid exclusively by business, or the taxes that business cannot shift. The general property tax was the predominant type of early American taxation, although various excises, customs duties, and license charges were also imposed. During the nineteenth century, special types of business taxation, such as those on corporations and those on particular industries, were gradually developed, along with license and occupation taxes in many states and business net income taxes in a few states. In this period the Federal Government relied heavily on customs duties and excises. The various property taxes still constitute the most important local taxes on business, although they are less important for the state governments.

Since 1900, income taxation has become a permanent feature in the tax systems of the Federal and of many state governments. In some states the business income taxes have provided more revenue than the personal income taxes, in others less, but the aggregate collections from the state business income taxes in recent years have been less than the receipts from the state personal income taxes. In the taxation of business profits, graduated tax rates have recently become more common. In its profits taxes, the Federal Government, indeed, has "gone graduated," and has abandoned the principle of the flat rate profits tax. The recent period has also been characterized by the revival of

the excess profits tax and the adoption of a new tax upon undistributed profits by the Federal Government. During the depression of the 1930's, both the business and personal income taxes have proved disappointing in their yield, since both taxes are directly influenced by changes in general economic conditions. The high exemptions of the personal income tax have also apparently contributed to its instability.

Since 1930 the state and Federal governments have drawn increasingly important revenues from commodity taxes. The excises have become more important, although customs duties have declined somewhat in importance. Many of the states have enacted general sales taxes, but there has been a recent tendency for some of the states to withdraw from the field of general sales taxation.

The various license, occupation, franchise, and capital stock taxes remain in confusing array, and are generally of minor revenue importance. Particular industries, such as banking and the public utilities, are still singled out for special taxation, and incorporated business is commonly segregated from unincorporated business for particular taxation. Since 1900, taxes on business for non-fiscal purposes have become more prevalent. Within the last five or six years, in fact, taxes are increasingly proposed as a phase of programs of social reform. As business transactions have spread across state and national boundaries, the complications and conflicts in business taxation have multiplied. As a result, there has appeared a greater degree of centralization of tax administration among the states and more cooperation among the state and Federal governments in meeting their mutual problems. Finally, business taxes have tended to become more, rather than less, complex. While some progress has been enjoyed in dealing with the problems of business taxation, new complications have created more perplexing problems that call for solution. Fortunately, the

interest in business taxation is growing, and the hope may be held that steady progress will be realized in dealing with the problems arising.

Property Taxation

The various types of business taxes offer certain advantages and disadvantages, which may briefly be considered. The general property tax has proved to be defective in the taxation of business as well as other property. Extraordinary difficulties arise in the assessment of business property because of its heterogeneous character, its technical features, and its distribution over wide areas. In order to reach the intangible values of corporations, franchise, capital stock, and corporate excess taxes have been employed. Centralized state administration has also been utilized in the assessment of certain property extending over large areas, such as the operating properties of public utilities. Local assessments have been equalized by state officials, but this procedure has generally failed to correct the original inequalities in assessment which constitute the chief weakness of property taxation. Colossal valuation problems, the evasion from taxation of personal property, the failure of various administrative reforms to eliminate the inherent weaknesses of property taxation, the opinion that intangible values were escaping their just share of taxation, and the more urgent revenue needs of the state and local governments have combined to hasten the adoption of other imposts upon business.

Taxes on Corporate Excess, Capital Stock, and Other Objects

The corporate excess and capital stock taxes are a species of property taxation designed to obtain more revenue from the intangible elements of business. Before the successful introduction of the state income taxes, the taxes on corporate excess were becoming increasingly popular, but with the

advent of the income taxes the taxes on corporate excess have become less popular because of the greater revenue possibilities of the income taxes and the fact that the income taxes are considered more adequate in reaching the intangible values of business.

Capital stock taxes have won wide favor among the states and have also been employed by the federal government. The Federal Government, under the present law, permits corporations to fix their own valuations for the capital stock tax, while the states employ the par value or an assumed value as the basis for taxation. The accurate valuation of capital stock has proved to be a well-nigh insuperable administrative problem. The par value or any other assumed value may be far from the market value or a fair value of the stock, so that many serious inequalities result in the levy of capital stock taxes.

The states have also developed franchise taxes in order to obtain additional revenues from corporations as payments for various privileges. They are supplemented by entrance charges on foreign corporations to equalize their taxation with that of domestic corporations. The value of the franchise is measured in several ways with reference to such factors as net income, capital stock, or the value of property or the volume of business in the state. Here, again, considerable diversity arises in the methods of taxation. The franchise tax is merely a nominal sum in some states, while it is a substantial tax in others. Upon close examination, both principles and practice in the levy of franchise taxes appear to be confusing and inconsistent.

In the Southern states, and to a certain extent elsewhere, there has been a tendency to employ state and local privilege, license, and occupation taxes on numerous types of business. These taxes are imposed without much rhyme or reason in many cases. The taxes may be based on the number of employees, the volume of output, and other ex-

ternal indexes, or they may be levied at a flat or graduated rate on the number of establishments operated. Such taxes have sprung up in great variety without rational planning. Sometimes the rate is purely nominal, at other times it is very high. Because of the crude bases of taxation and the haphazard methods of assessment, these taxes give rise to grave inequalities and have often been condemned by tax students.

The miscellaneous business taxes upon corporate excess, capital stock, corporate franchises, and other objects are generally of only minor revenue importance, and are appendages to the primary imposts upon property, earnings, and receipts. In many instances they could be abolished with consequent gains in simplicity, uniformity, and justice.

Receipts Taxes

Another group of taxes, upon commodities handled by business, are highly significant as revenues and have recently become more important. The commodity taxes are commonly collected in relation to the receipts or sales of business, but they may be imposed upon the purchase or use of commodities, upon the privilege of selling commodities, or other objects. These taxes possess the common characteristic that in the economic sense they are taxes upon commodities or services, whatever legal basis they may have. They also tend to be shifted to consumers, yet they place many costs and repercussions upon business. The excises, sales taxes, and customs duties are the best known of the commodity taxes, but other types are also employed.

In recent years the American commodity taxes have become of greater revenue importance than any other type of taxation, except that on property. The most productive of the commodity taxes are those upon gasoline, tobacco, and alcoholic beverages. Substantial revenues are also derived from the various selected and general sales taxes and

the customs duties. The commodity taxes are frequently classed as consumers' taxes because they tend to be paid ultimately by consumers, but business must bear the unpleasant responsibility of paying these taxes to governments and of then trying to shift them to buyers, the expenses of computing the taxes, and their reactions upon sales, profits, and other factors.

The commodity taxes are the source of an irritating dilemma. If business cannot shift them, they press unequally upon the various enterprisers because of their disregard of net income, the rate of return on the investment, debt charges, and other variable but significant factors in business. If such taxes are shifted to consumers, on the other hand, they are regressive in their effects and pinch the poorer consumers harder than the richer. In spite of their inequalities, commodity taxes have become noted, in certain instances, for providing large and relatively stable revenues during a long and severe depression; they broaden the tax base and permit governments to tax the masses under cover; they may be collected conveniently from business units; and they are preferred by many business executives to profits taxes because they tend to be shifted while profits taxes tend to stay with business.

Commodity taxes are the mainstay of the Federal revenue system and in late years have become of increasing importance to both the state and Federal governments. They may decline in relative importance in the future as the income tax returns to a position of greater prominence as a revenue, but there are no present indications that commodity taxes will generally be relinquished by the state and Federal governments. Gross receipts taxes have been extended to public utilities and other classes of enterprise by the states. Where they have been substituted for property taxes in reaching public utilities, it has still been necessary to estimate the value of public utility property so that their taxation

may be equalized with the taxation of other property. Both the ad valorem and gross receipts taxes have been warmly defended and roundly denounced in their application to public utilities. Both offer certain advantages and suffer from important disadvantages. The gross receipts principle has also been employed in other fields, as in the taxation of insurance companies, where gross premiums may be the basis of taxation. All types of gross receipts taxation suffer from inherent inequalities, but their revenue advantages have been appealing to governments.

Net Income Taxes

Increasingly since 1900, the critics of business taxation have urged the substitution of the net income tax in the place of the special property taxes, franchises, corporate excess, capital stock, license and occupation taxes. Many persons have also proposed the use of business net income taxes instead of the adoption of additional commodity taxes by the state and Federal governments. The corporate income tax has long been a productive revenue for the Federal Government, and is now employed by over half of the states. The net income of business is generally taxed at a flat rate by the states, but some of the states have employed graduated rates, along with the Federal Government, which now imposes three graduated taxes on normal profits, excess profits, and undistributed profits.

Many tax authorities believe that the net income tax is the most equitable of business taxes, but even it is far from perfection. A tax collected at a flat rate treats all business enterprises nominally alike, but it actually discriminates against particular business units because the tax rate is uniform regardless of the amount of net income, the rate of return on the investment, the tendency of a business to experience regular or highly fluctuating earnings, and other variable factors among different industries and individual

enterprises. Yet a uniform rate structure is simple and is recommended by many tax students as the fairest of the various rate schemes.

Graduated business income taxes suffer from the disadvantage that they penalize corporations with widely fluctuating earnings with a high tax rate in their most prosperous years irrespective of the heavy losses that may be experienced in off years. Graduated rates are also of no great value in stabilizing the collections from profits taxes, contrary to the recent arguments of the Federal Government, because they do not greatly increase the proportion of the total taxes paid by the larger income enterprises, which normally pay nearly all of the net income tax anyway.

Excess profits taxes at graduated rates rest upon sound theoretical arguments, because they tend to tax the corporations with the highest rates of return on investments at the highest rates and they permit governments to draw substantial revenues from huge war profits and monopoly gains. But excess profits taxes have thus far proved to be impracticable of administration as permanent revenues because of the serious obstacles to be overcome in securing accurate valuations of corporate investments. There is also a weighty problem to be overcome in separating a normal from an abnormal rate of return.

Excess profits taxes are open to the further criticism that they have a tendency to rest more heavily on the successful small corporations than on the large, because the smaller successful corporations usually enjoy higher rates of profit than the larger, and also because the earnings of the smaller corporations tend to fluctuate more than the earnings of the larger. As a result of the latter tendency, a small corporation with a series of deficits or with relatively low profits over a period of years may pay a high tax rate in its years of prosperity, while a large corporation with relatively stable earnings but with a higher average rate of return on its in-

vestment, may escape from the excess profits tax either largely or entirely. The excess profits tax has also been criticized for discouraging investments in the industries with very uncertain earnings, as in mining or in the promotion of new inventions, which may be of inestimable social advantage. If an excess profits tax is employed, it would seem to be the policy of wisdom, from the standpoint of equity, to impose the tax with reference to the average rate of profits over a period of years in order that allowance would be made for deficits and unusually low earnings in some years. There appears to be a tendency to regard the excess profits tax as an emergency impost which may be justified on the basis of its productivity under favorable conditions, but which is not defensible as a permanent revenue.

Taxing Corporate and Noncorporate Enterprise

Another practice in business taxation, or the separation of corporate and noncorporate enterprise for particular methods of taxation, should also receive attention here. Both the Federal and the state governments have customarily collected certain taxes from corporations which are not collected from unincorporated business, although in other cases, all types of enterprise may be taxed without distinction, as in the taxation of real estate or receipts. Franchise, capital stock, and various profits taxes are commonly imposed upon corporations but not upon noncorporate business. In some states, an unincorporated business tax has been introduced. The owners of unincorporated businesses are, of course, customarily taxed on their incomes where a personal income tax is collected.

The special taxes on corporations are defended as measures that are necessary to equalize the taxation of corporate and noncorporate business, and that are a fair payment for the peculiar advantages enjoyed by corporations. These advantages are frequently exaggerated by legislatures, which

overlook the fact that the particular advantages of corporations may be reflected in their earnings, property, or receipts, and disregard the fact that the proprietorship and the partnership forms also possess specific advantages which might call for special taxation. The corporation taxes are, to a considerable extent, a symptom of the antagonism to big and bad business. Since the larger concerns are usually incorporated, governments have found political support in playing off the corporations against the numerous small unincorporated enterprises in the formulation of tax policies.

Conflicting Taxation

An examination of the various types of business taxes reveals that none is free from defects, but that some taxes are less objectionable than others. Since no tax is perfect, the problem to be faced is the choice of the least objectionable of the available revenues. The evils of business taxation are aggravated by the common tendency to superimpose one bad tax upon another, on the supposition that two bad taxes may become two good taxes when collected simultaneously because each supposedly neutralizes the ill effects of the other. Confusion and chaos result from excessive diversity and odd assortments of taxes levied by particular governments. The conflicts in taxation are further intensified by the divergent practices of numerous competing governments, which strive to outdo each other in augmenting their revenues from business that crosses state boundaries. There is no real system of American business taxation; instead there is only a hodge-podge of taxes imposed by independent jurisdictions without much regard for the practices of other governments.

There are several outstanding reasons for the serious conflicts between governments in taxing the same objects. (1) The individualistic American governmental structure, consisting of approximately 175,000 units, has not been coordi-

nated in its functions, so that tax conflicts are inevitable. Governmental boundaries are definitely limited, whereas business transactions disregard state lines. (2) American taxation, generally speaking, is not a rational development. Its evolution has been controlled by political, social, economic, and fiscal expediency more than anything else. No one wants to be taxed, so that the resulting taxation is the outcome of numerous compromises with influential pressure groups. (3) The legislative bodies which enact tax laws are experts in the politics of taxation but novices in the economics of taxation. They are largely ignorant of the principles of sound taxation. (4) The theories of business taxation are conflicting and inconsistent; they call for thorough reconstruction. (5) Productivity has thus far been considered more important than justice in taxation. Justice and other important factors have been regarded as incidental to obtaining revenues with the least friction.

The Principles of Business Taxation

The methods and the principles of business taxation cannot be separated, because the methods which governments apply are but the expression of the principles which they accept. The bewildering diversity of practice and the inequalities in burden are reflections of the efforts to execute improper, impracticable, or inconsistent principles of business taxation. Indeed, one may doubt if any purely rational theory of business taxation can be followed as long as the political limitations of pressure groups and our individualistic plan of government prevail. The problem of the future is to devise principles of business taxation that are sound as well as practicable. This involves the broader problem of reconstructing American government so that rational taxation may exist and may be encouraged.

A brief appraisal of the popular theories of business taxation that are now supposedly applied will indicate some

of their shortcomings and the need for future reforms. Perhaps the most commonly accepted principle of business taxation is that of benefits. It is a plain statement of fact that business enterprises do enjoy valuable benefits from government services; and one may argue that business units should pay taxes arranged according to some definite relationship with the value of the benefits obtained from public services. But no object, be it property, receipts, gross income, net income, or any other, is adequate to measure the value of those benefits. The benefit principle justifies some kind of business taxation, but it does not indicate precisely how business should be taxed, or how much taxation business should pay. Perhaps a combination of property, receipts, and net income would be the most suitable measure of benefits, but such an index, like others, is arbitrary and would cause numerous inequalities in taxation. The benefit principle, in practice, fails to explain many business taxes, which are levied without regard for the particular benefits that business concerns may secure from government.

The cost of service theory, again, justifies some sort of business taxation, since business does occasion the undertaking of expensive government functions, but there is no practicable method whereby the additional governmental costs for which each business unit is responsible may be determined. It may also be argued that governments are silent partners in business, and that the success of every business undertaking depends upon the social opportunities and facilities at its disposal. This theory, however, does not reveal the proper limits of business taxation or the proper methods. Since all business exists under State sanction, it might go so far as to confiscate private industry by taxation and establish collective industry.

Many persons, including high government officials, have advocated particular taxes because they considered these taxes consonant with ability to pay. In the popular mind,

this theory has been little understood. It has been brought to the defense of nearly every tax, regardless of how the tax may affect the individual owners of a business or the individual consumers. It may be argued that business enterprises, engaged as they are in productive activities, possess a collective capacity or ability to pay taxes distinct from the individual abilities of the owners or the consumers of their products. But no practicable and satisfactory method of measuring and taxing such impersonal ability to pay has yet been perfected, although such arbitrary factors as net income and the rate of return on the investment have been suggested. It is true that the abilities of individuals to pay taxes should be weighed in constructing tax systems, but the principle of ability to pay has thus far been of little help in developing business taxation.

Another principle of business taxation which has found great favor among social reformers is the non-fiscal or regulatory theory. In recent Federal, state, and local tax measures many expressions of the regulatory theory will be found. Taxation for regulatory purposes is logically defensible when it is the best means of accomplishing a socially desirable purpose, but all too often the objective in view is the protection or indirect subsidization of a favored class at the expense of society and of competing interests.

Experience has repeatedly demonstrated that regulatory business taxation is fraught with grave dangers. Pressure groups are ever eager to promote their selfish welfare, and questionable methods may be employed to accomplish reforms of dubious merit. Where the ends in view are commendable, it may happen that the taxes proposed to further those ends are ineffective. Every plea for the enactment of a regulatory business tax should be scrutinized with the greatest care because of the common abuse of the regulatory principle in tax systems.

Conclusions

With this brief appraisal of the methods and principles of business taxation in the United States, we may now proceed to state more definitely the problems of business taxation and suggest a desirable line of reform. From the fiscal standpoint, looking at the problem through the eyes of government officials, the problem of business taxation is to obtain adequate revenues at the least cost and with the minimum resistance. From this angle, governments may prefer relatively stable commodity and property taxes to net income taxes in periods of depression, if not in prosperity. In prosperous periods governments sing the praises of their income taxes, but during hard times they forget many of their virtues. Governments may also prefer commodity taxes to more direct imposts because the concealed indirect charges may arouse less political resentment.

From the business standpoint, the problem is to obtain lighter taxation where possible—lower costs of computing taxes, lower costs of litigation, and lower tax payments. Business also wants more simplicity, uniformity, and convenience in taxation. It desires the elimination of nuisance charges of all kinds which produce little revenue and are inequitable in their burdens. Business would also prefer a greater centralization of tax administration in order to secure more uniformity, simplicity, and convenience in taxation, although the present hostility of the Federal Government to the larger corporations presumably does not create much enthusiasm for the proposal that the Federal Government should impose all business taxes.

From a more detached social point of view, the problem of business taxation is to remove harsh inequalities in tax burdens, to secure more rational tax planning for long-run periods and fewer compromises with expediency, to obtain the abandonment of a multitude of small business taxes

which are inconsistent with rational principles of taxation and which supply relatively little revenue, to eliminate unnecessary tax conflicts among competing governments and to substitute the coordination of Federal, state, and local taxes, to encourage the development of a unified and consistent system of business taxation that will supplant the present conglomeration of unbalanced and frequently ill-advised taxes, and to accomplish the restatement of the principles of business taxation so that a solid foundation may be laid for the business taxes of tomorrow.

The Model Business Tax, which has been proposed by a committee of the National Tax Association, for state and local governments, is worthy of thoughtful study. It suggests a program of reform which has been endorsed by many tax authorities, a program which may serve as the basis for the discussion of desirable reforms in business taxation. The essential feature of this plan is the repeal of the numerous franchise, capital stock, corporate excess, license, occupation, and other special business taxes and the substitution of a business net income tax for them. It is proposed that the net income of business enterprises should be allocated among the states for taxation according to the Massachusetts formula, which gives equal weight to each of three factors: (1) the ratio of tangible property within the state to the total tangible property of the concern, (2) the ratio of sales within the state to the total sales, and (3) the ratio of the payroll within the state to the total payroll.

To assure governments of a steady stream of revenue during the years when enterprises have no net earnings and to obtain some taxes from enterprises which enjoy some benefits from government even though they earn no net income, it is suggested that a minimum tax should be imposed either on gross receipts at a rate not exceeding 0.1 per cent or upon property at a rate not exceeding two mills on each dollar of

valuation, when no income tax would be paid.[2] The rate of the business income tax is to be moderate; it is to be a flat rate, and not graduated.

The Federal Government might well take immediate steps to abolish the impracticable and inequitable excess profits tax and the capital stock tax. The normal profits tax should be retained, but the scheme of graduated rates should be abandoned because of the fundamental objections to graduated rates in ordinary business profits taxation. The undistributed profits tax may be justified in principle, but if the law is retained it should be rewritten to remove the highly complicated, oppressive, inequitable, and irritating features, and the tax should be levied at a moderate flat rate. Both the Federal and the state governments should labor for the erection of a system of business income taxation and should give up the attempt to tax the income of corporate and noncorporate enterprises in a fundamentally different manner. That is, all business income should be taxed as business income, and the income of unincorporated businesses should not be taxed as personal income.

[2] For the details of the Model Business Tax see the *Proceedings of the National Tax Association*, 1933, pp. 391–399.

CHAPTER V

EUROPEAN TAXATION OF BUSINESS[1]

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ANY discussion of business taxation must begin with a definition of the term. For the purposes of this paper business taxes have been limited to those imposed on trade and industry as such. Taxes which are imposed on business property and income equally with other property and income, such as real estate and personal income taxes, have been excluded.

The taxes included under this definition have been classified as (1) general business taxes, (2) special business taxes, and (3) corporation taxes.

General business taxes are those that are levied in the same manner on all, or almost all, business concerns, regardless of the kind of business and the form of business organization. The two outstanding taxes in this group are the net income tax and the turnover tax.

Special business taxes are those applying to particular kinds of business. They may take the form of net income or gross receipts taxes, or they may take the form of license taxes determined by other criteria than gross or net income.

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[1] In preparing the following account of business taxation in Europe it has been necessary to depend in large part on secondary sources. In only a few instances were the actual tax laws available. Also it has not always been possible to bring the information down to date. It is believed, however, that the taxes described have been in force within the past three years, at least. The sources used most have been: *Tax Systems of the World*, 6th ed., 1935; League of Nations reports, especially *Taxation of Foreign and National Enterprises*, 1933; Statistisches Reichsamt, *Einzelschriften* nr. 9, 1929; nr. 19, 1931; *Handbuch der Finanzwissenschaft*, bd. 3, 1929; National Tax Association, *Bulletin*, *passim*.

Customs duties and a wide range of consumption taxes might be included in this list, since they are paid in the first instance by the business concern, and are probably borne in part by the taxpayer; or they might be excluded on the assumption that it is anticipated that they will be shifted to consumers. Largely because of the limitations of space, domestic consumption taxes have been ignored except where they are an important part of the tax system. Customs duties have been excluded since they do not fall primarily on the domestic business concern.

Corporation taxes are not inevitably business taxes. Many of them, however, are limited to business corporations, or reach so few other corporations that they are essentially business taxes.

General Business Taxes

The general business tax on net income is unknown in the United States, unless the taxes—at different rates—on the net income of incorporated and unincorporated business concerns in New York State may be regarded as such a tax. The tax on business income is, however, a very common form of taxation in Europe. Two varieties of this tax are to be found: (1) a tax that is independent of, and usually in addition to, any personal or corporation income taxes that may be levied; and (2) a tax that is an integral part of the system of net income taxes.

When the first form of tax is levied it usually means that business profits are subject to two or three separate taxes. This is true in Germany, for instance, where corporation income, in so far as it is distributed, is subject to the national corporation and personal income taxes and to the state business income tax. This multiple taxation is, of course, no different from that to be found in the United States under federal and state taxes on personal and corporation incomes.

All the German states[2] employ the business income tax for state or local use, or for state and local use. The base varies from one state to another, and the rate usually varies from one local district to another although a maximum rate is generally fixed.

A detailed account of these taxes cannot be given here, but they have enough similarities to justify describing the usual practice. The tax covers all businesses and professions with the general—but not universal—exemption of agriculture, national, state, and municipal enterprises, and organizations for the promotion of the general welfare. Cooperative organizations are occasionally exempted.

In most states the general business tax has a double base: net income and capital. Usually the deduction of interest on borrowed capital is not allowed in measuring taxable income, nor is the deduction of borrowed capital allowed in measuring taxable capital. Real estate subject to the real estate tax is deducted, however, before measuring taxable capital. Payrolls are used in Prussia as an alternative base to capital, at the discretion of local governments. No tax is levied for state purposes in Prussia. Payrolls are likewise found in some of the smaller states as additional or alternative bases to capital.

The basic rate schedules vary so much from state to state, and the local additions vary so much from commune to commune, that generalization is difficult. Both the tax rates on income and on capital are progressive, however, and there are frequently exemptions for small business enterprises, especially unincorporated enterprises.

In Prussia the basic rate scale varies from one-half of one per cent to 2 per cent, the maximum being reached at the comparatively small income of 3,900 RM. This is not,

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[2] This term is used to apply to the former states which, under the National-Socialist regime, have lost the independence that justified the designation of State. These *Länder* have retained, however, their varying tax systems.

in itself, a high rate, but most cities levy rates of five times this amount, or more, and rates in excess of seven times this base can be found. In Dortmund, e.g., a rate scale varying from 3.6 to 14.4 per cent has been levied in recent years.[3]

The basic rate scale on business capital in Prussia varies from one-twentieth of one per cent to one-fifteenth of one per cent. When this is multiplied 20 or 25 times, as it is in some city levies, it becomes a rate of more than one per cent on capital.

The alternative payroll tax in Prussia has a basic rate of one-tenth of one per cent, but this has been increased to nearly 3 per cent by the multiple applied in some city levies. Dortmund, with a tax of over 14 per cent on income, levies almost 3 per cent on payrolls in addition.[4]

Similar business income taxes are to be found in other countries. In Czechoslovakia corporations are taxed according to a different scale of rates from individual enterprises but otherwise the taxes are the same. In Austria the corporation tax is an independent tax, professions are taxed at different rates from ordinary business enterprise, and local surtaxes are not permitted. Other variations are to be found in other countries, e.g., Danzig, Estonia, Greece, Latvia and Luxemburg. In none of these countries is the business income tax combined with a tax on capital or payrolls, as in Germany.

The business income tax which forms an integral part of the system of net income taxes can be regarded as a business tax only in that business income is subject to a different rate from income from other sources. In France, for example, the rate on business profits is 12 per cent as compared with a rate of 6 per cent on wages and salaries. In Italy, also, the rate on business income exceeds that on

[3] *Statistisches Jahrbuch Deutscher Gemeinden.* 1934, 1935, and 1936.

[4] These payroll taxes are, of course, in addition to the payroll levies for unemployment insurance which, in recent years, have exceeded 6 per cent,—one-half to be borne by the employer and one-half to be borne by the employee.

salaries and wages. Progressive rates are not applied to business income as such. Business income is not always subjected to a higher rate than any other kind of income, but the rate is almost always higher than rates on earned income.

These taxes are roughly comparable to the normal income tax in the United States. They differ in having an elaborate classification of income by sources whereas our normal tax makes a limited distinction between earned and unearned income. Furthermore, corporation income is often included. In addition to France and Italy, such a tax is to be found in Greece. A variation of this form of taxation is to be found in Rumania. Here progressive income taxes are applied to income from each source, the amount of income an individual derives from a single source rather than his total income determining the rate he pays. Thus the individual with income from a variety of sources pays a lower tax than an individual with an equal income from a single source. The scale of rates for business income is, as in the case of the flat rate taxes in other countries, higher than the scale of rates for earned income.

The turnover tax is to be found in the majority of European countries. It is not levied in Great Britain, nor in the Scandinavian countries, but elsewhere it is all but universal. The retail sales tax found in so many American states has no replica in Europe. Some of the European turnover taxes levy a different rate on retail sales from the rate levied on other sales, but the tax is not limited to retail sales. In some countries retail sales are exempt, and in others sales of middlemen are exempt. Most of the taxes, however, are fairly comprehensive taxes on practically all turnover.

Rates of turnover taxes vary sometimes with the commodity, and sometimes with the kind of sales, i.e., whether the sale is by the manufacturer, the middleman, or the retailer. Rates vary also from country to country. The

rate of 2 per cent is to be found for most sales under the very comprehensive taxes levied in such countries as France, Germany, Belgium, Austria, and Hungary. Luxury sales taxes usually carry rates of 10 per cent and over.

Special Business Taxes

Special business taxes cover a wide range of activities. The taxes levied most generally are taxes based on the gross receipts of transport and insurance companies. The taxes on stock transfer, real estate transfer, and bills of exchange that are to be found in France, Germany, Italy, Switzerland, and a number of other countries, are usually in the form of stamp taxes varying with the value of the transfer. Other stamp taxes are common, both at flat and variable rates.

Amusement taxes are frequent. Sometimes these taxes are national, but they are often local. Other common local business taxes are taxes on inns, restaurants, and itinerant trade. Other special business taxes found occasionally are betting taxes and taxes on mining rights. Discriminatory taxes on chain stores are to be found in some of the German states.

Finally, there is a wide range of commodity taxes, based sometimes on value and sometimes on quantity, and levied sometimes on the manufacturer, sometimes on the distributor, and sometimes on both. The commodities most frequently selected for these taxes are spirits, liquor, beer, tobacco in all forms, and sugar. Other commodities commonly taxed are salt, matches, playing cards, explosives, and petroleum products. Excise taxes on specific domestic products are universal, in spite of the widespread use of general turnover taxes, and they are usually the source of substantial revenues. In some countries a state monopoly has been established in place of a tax for some of these commodities.

Corporation Taxes

Corporation taxes are to be found in wide variety among the different European countries, but the great majority of these taxes are in the form of net income taxes. The corporation organization tax, based on authorized capital stock, that is so widely used in the United States, is almost unknown in Europe. Taxes are found occasionally, however, on the issue or first sale of capital stock. Belgium, Germany, Iceland, The Netherlands, and Switzerland levy taxes of this nature. The annual tax on capital stock is even more exceptional than the tax on the original issue, but such a tax is used by some of the Swiss cantons. Special corporation property taxes are also rare, except as the basis of a minimum tax for companies with no net income. Denmark and Finland, however, levy special progressive taxes on corporate property, Norway levies a corporation property tax at a flat rate, and The Netherlands levies a regressive tax on such property.

Corporation income taxes are levied both at flat rates and on progressive scales. For twenty-two countries for which such taxes have been found, eleven have flat rates and eleven have progressive rates. The flat rate taxes are often independent taxes, as in the case of Austria, Germany, Norway and Czechoslovakia. Again they are levied as a part of the general income tax, as in the case of France, Italy and Greece. In these cases the corporation tax can be differentiated from the personal income tax only in that corporations escape the surtax. The rate levied on corporation income differs with the source of income but is the same as the basic rate for income from this source for private individuals. Flat rate income taxes are as high as 20 per cent of income in Germany, Danzig and The Union of Soviet Socialist Republics, but in most countries levying such a tax they range from 7 to 15 per cent.

Those countries levying a net income tax at progressive rates on corporations have for the most part established a different scale of rates from that used for natural persons. For the most part rates are high and rise rapidly, reaching the maximum rate on comparatively small incomes. The actual maximum rates in force range from 10 to 30 per cent. Little or no allowance is made in personal income taxes for the fact that dividend income has already borne a heavy tax.

A few small countries have levied progressive income taxes on corporations at the same rates as on natural persons. The ultimate tax burden on corporations and natural persons differs even in these instances, however, because of minor adjustments. In one country corporations subject to excess profits taxes are exempt; in another country the maximum rate for corporations is set lower than that for individuals, and in a third country an adjustment is made for income paid out in dividends. With or without these minor variations the corporation income tax imposes an additional burden on corporate income, in so far as it is paid out in dividends, since the personal income tax, as noted above, usually makes no allowance for this. Those countries taxing income at different rates do not usually favor income from dividends with a low rate. Just why so many countries should have chosen a progressive income tax on corporations is not clear. It certainly cannot be defended on the same ground as the progressive tax on personal income. There may be, of course, a desire to favor the small concern. In this connection it is interesting to note that Germany, which has definitely favored big business—at least until the present government came into power—levies a flat rate on corporate income.

Two forms of corporation taxes remain to be described: the excess profits tax and the tax on undistributed earnings. Few instances of either form of tax are to be found.

Sweden, Estonia and Latvia, however, levy excess profits taxes. The Swedish tax is the only special corporation tax levied in this country. In Estonia and Latvia corporations are also subject to a progressive income tax, and to a small tax on capital if the excess profits tax drops below a certain minimum.

Undistributed Profits Taxation

The undistributed profits tax is found in Norway, Czechoslovakia, and some of the Swiss cantons. The Norwegian tax is levied at a flat rate (8.8 per cent), and is in addition to a tax of 8 per cent on net income and a tax of two-tenths of one per cent on property. In Czechoslovakia the undistributed profits tax is linked with a tax on dividends. Undistributed profits are taxed at 8 per cent and dividends in excess of 6 per cent are taxed at 6 per cent. Thus dividends up to 6 per cent have a decided tax advantage and dividends in excess of that amount have a slight tax advantage.

The undistributed profits taxes in the Swiss cantons are much higher. Rates are 50 and even 65 per cent. A maximum is set, however, in relation to the total income; that is, the tax may not exceed a certain—much smaller—percentage of total net income. In Geneva, for instance, where the rate on undistributed profits is 65 per cent, the maximum tax is limited to 13 per cent of total net income. Thus if a corporation retains its entire net income it is taxed at 13 per cent of undistributed profits. If it retains only one-fifth of its net income the tax will be 65 per cent of its undistributed profits, but the absolute amount of the tax will be the same as though it had withheld all its income. Thus the tax does not encourage the distribution of income, as do most undistributed profits taxes, except within the range of 80 to 100 per cent distributions.

No attempt has been made in the above discussion to distinguish among the various forms of corporations, joint

stock companies and cooperatives. In general there is no differentiation in the tax levied, although there is some tendency to tax cooperatives and non-business corporations at lower rates than profit-making organizations.

Summary

It is apparent from this brief review that practically every form of business tax to be found in the United States has some counterpart in Europe. There are differences in the extent to which different taxes are employed, however. In the United States business has been specially taxed through the corporation, if at all. The only important exceptions to this are the general sales taxes, excises on specific commodities, and local business license taxes. In Europe, however, business income is quite generally taxed as such regardless of the form of organization.

Corporation taxes, on the contrary, are not as universal in Europe as in the United States, and the American practice of taxing authorized capital stock upon organization, and stock outstanding annually, has not been followed in Europe. Corporation income taxes, however, are important sources of revenue in many European countries, as in the United States.

Business Taxation in Germany and Great Britain Contrasted

No attempt has been made to describe business taxation by countries, and the striking contrasts that are to be found are hardly apparent from the piecemeal description above. Some idea of the differences can be given by contrasting the systems of the two big industrial countries of Great Britain and Germany.

Great Britain does not tax business as such, or corporations as such. When a few stamp taxes, a substantial number of excise taxes on specific commodities, and the mineral

rights duty have been named the list is complete. There are no general business taxes and no corporation taxes. In contrast to this there are in Germany general business taxes on net income (and often on capital or payrolls also), and corporation income taxes. There is also the "industrial assessment," based on assets. Furthermore Germany has a general turnover tax where Great Britain has none, and also a series of excises and stamp taxes comparable to those in Great Britain. The mineral rights duty is not found in Germany but special business taxes are found on insurance, transport, and betting.

Nor is this all. The British government contributes to the unemployment insurance fund from general revenue to reduce the charges on payrolls, whereas the German government uses surplus unemployment insurance funds (derived entirely from payroll levies) for general relief. And where local governments in Germany depend in large part on the general business taxes and on special taxes on amusements, inns, and drinks, the local governments in Great Britain are not even permitted to levy the same rate on rentals of certain business properties as on other rentals. Since 1929 manufacturing, mining, and railroad property has been "derated" to the extent of three-fourths of its value.

It is impossible to say whether business carries as heavy a load in any other European country as it does in Germany, but it is safe to say that no country has favored business through its tax system as much as Great Britain.

CHAPTER VI

FLAT VERSUS GRADUATED RATES FOR BUSINESS NET INCOME TAXES

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THE weight of authority has favored flat rates of taxation on business net income. The National Tax Association Committee on a Model System of State and Local Taxation reporting in 1919 stated that "obviously the rate of the business tax should be proportional and not progressive."[1] The second report of that committee in 1933 repeated the statement.[2] Of 114 professors of public finance answering the recent questionnaire of the New York State Tax Commission, 68 favored flat rates for corporation income taxes. Opinion is by no means unanimous, however. Forty-six of the 114 favored graduated rates.

The weight of usage also has favored flat rates. The only state income tax applied especially to unincorporated business—that of New York—has a flat rate.[3] A large majority of state corporation income taxes are imposed at flat rates.[4] Prior to 1935 the rate of the federal income tax was flat.[5]

Progressive rates also have been used, however. The first modern state corporation income tax—that of Wiscon-

[1] *Proceedings of Twelfth National Conference,* National Tax Association, 1919, p. 454.

[2] *Proceedings of Twenty-sixth National Conference,* National Tax Association, 1933, p. 397.

[3] New York. Tax Law, Art. 16-a.

[4] See *Tax Systems of the World* (Chicago, 1935), pp. 128ff.

[5] For example, see Revenue Act of 1934, Sec. 13(a).

sin—was at progressive rates. Six states, including Wisconsin, now impose progressive rates on corporation income.[6] Some of the taxes, however, are only slightly progressive. In all but one state the maximum rate is reached at an income of $15,000 or less.

Prior to 1932 the Federal corporation income tax was given a slight degree of progression by the exemption of $3,000 of net income.[7] Since 1935 the Federal tax has been imposed at progressive rates. Those of the 1935 act ranged from 12½ per cent on the first $2,000 of income to 15 per cent on income above $40,000.[8] The 1936 rates ranged from 8 per cent on the first $2,000 to 15 per cent on income above $40,000. The progression is thus much less extreme than in the personal income tax. The maximum rate is less than twice the minimum. Progression stops at a much lower point and the lower rates affect much less income. Over three-fourths of the total corporation taxable income of 1932 would have been subject to the maximum rate of the 1936 act although not more than 6 per cent of the corporations having taxable income received more than $40,000.[9]

Although the present mild application of progressive rates on business income is not of much significance in itself, the issue of progressive rates is likely to be important in the future. It deserves careful consideration.

Tax policies are not inherently either good or bad. A tax device that fulfills an aim of the tax system is good from the viewpoint of that aim. A tax device that fails to fulfill or prevents the fulfillment of an aim is bad from the viewpoint of that aim. Some aims that are important in the minds of those determining tax policy are ease of admin-

[6] *Tax Systems of the World*, pp. 128ff.

[7] Revenue Act of 1928.

[8] Revenue Act of 1935.

[9] Computed from *Proposed Taxation of Individual and Corporate Incomes, Inheritances and Gifts*, Hearings before the Committee on Ways and Means, House of Representatives, 74th Congress, 1st Session, July 8–13, 1935 (Washington, 1935) p. 19, quoting table from *Statistics of Income*.

istration, stability of revenue, justice, and social control. The question discussed by this paper is whether flat or progressive rates of business income taxation more nearly achieve these tax aims.[10] Taxation of corporations will be discussed before that of unincorporated business because corporation taxation involves all important policy questions of unincorporated business taxation and others in addition.

Ease of Administration

Ease of administration is reflected largely in low cost of administration. No difference in the cost will likely exist in administering a tax with a flat rate and one with progressive rates as long as the same taxpayers are subject to the tax. If, however, progression is carried to so high a rate that efforts at evasion increase, the cost of administration will also increase.

Stability of Revenue

Another aim of a tax system is stability of revenue. While stability is not usually considered as important as other aims it is usually deemed desirable. In general, progressive rates make the revenue yield of a tax less stable. The assertion has been made, however, that the yield of a corporate income tax at progressive rates would be more stable than at flat rates.[11]

Stability of revenue depends on the stability of the amounts of income in different brackets to which different

[10] Evaluating tax policies by relating them to tax aims is developed in a forthcoming publication of the Twentieth Century Fund on taxation in the United States. The present writer has drawn heavily on an analysis of corporation income taxation by Professor Carl Shoup in that work.

[11] At the hearings before the Senate Committee on Finance on the Revenue Bill of 1935, Robert H. Jackson, Assistant General Counsel, Treasury Department, said "The Treasury, in the light of information now available, is of the opinion that the graduated income tax proposed by the President, which will base revenue yield more upon larger and less upon small corporations, would produce a more reliable, predictable and steady flow of revenue to the Government than the present flat rate of tax for all." *Revenue Act of 1935*, Hearings before the Committee on Finance, United States Senate, 74th

rates are applied. Unless the amounts of income in the higher rate brackets are more stable than in the lower brackets progressive rates do not increase stability of yield. Furthermore, unless the total income of all corporations with large incomes is more stable than the total income of corporations with small incomes, the amounts of income in the higher tax brackets will be less stable than in the lower brackets, since a corporation to have income in the higher brackets must also have income in the lower brackets.

For the years 1929 to 1932 figures submitted by the Treasury Department to the Committee on Ways and Means[12] show upon analysis that large corporate incomes were less stable than were small corporate incomes. The coefficients of average deviation from the mean for the total incomes of corporations with incomes (1) under $50,000, (2) between $50,000 and $500,000, and (3) over $500,000 were 44, 50 and 53 per cent respectively. Total amounts of income in higher brackets were necessarily even more unstable compared to incomes in the lower brackets than these figures indicate. Furthermore, the application of progressive rates would tend to increase the instability of yield since in years of low incomes a larger proportion of the incomes would be taxed at lower rates than in years of high incomes.

The period 1929–1932 is too short to warrant general conclusions but the evidence points toward greater stability of revenue with flat rates than with progressive rates.

Congress, 1st Session, on H. R. 8974, July 30-August 8, 1935, p. 213. The figures presented in support of this opinion showed that in recent years there was greater fluctuation in the percentages of income and loss to capital among smaller corporations than among larger corporations (pp. 210–212). The evidence was not claimed to be conclusive. It may be doubted, furthermore, whether the conclusions really follow the evidence. The lack of uniformity in percentages of income to capital does not necessarily affect the stability of the tax yield. Different corporations may have widely different rates of return but if these remain the same from year to year stability of yield is not reduced. Even if rates of return of individual corporations fluctuate widely from year to year instability of revenue may not result if returns of different corporations are fluctuating in different directions.

[12] See note 9.

Justice for Personal Taxation

Justice is a third aim of a tax system. Progressive corporation income taxes have been proposed as being more just than flat rates.[13] For an analysis of justice the corporation income tax may be considered (1) a personal tax collected at source, (2) a semi-personal tax collected at source on income derived from corporation dividends, or (3) a purely impersonal tax on corporations as such.

The burden of the corporation income tax is generally believed to fall on the stockholders. The common stockholders bear the main burden as they are the residual claimants of earnings. The preferred stockholders are affected if earnings after taxes are not sufficient to pay their dividends. Whether the rates of the corporation tax are proportional or progressive, the burden for any corporation falls proportionally on all its common stockholders. Likewise it falls proportionally on the members of any class of preferred stockholders. The owner of 10,000 shares suffers the same proportional loss of income as the owner of 10 shares.

A personal tax is just when the same amounts are paid by persons having the same total economic situation, and when differences in the amounts paid bear an equitable relation to differences in total economic situation. Total economic situation is usually measured by total net income although wealth, size of family, and other factors are also important. Corporation income taxes are in no way adjusted to variations in the total income or other circumstances of different

[13] In his message of June 19, 1935, President Roosevelt recommended graduated corporation tax rates partly on grounds of justice. *Revenue Act of 1935*, Hearings . . ., *op. cit.*, p. 3. Robert Jackson made a statement for the Treasury Department containing the following language: ". . . from the Treasury's viewpoint they [facts showing increasing concentration in large scale corporations] point to a source of revenue to be drawn upon in accordance with ability to pay.

"The ability to pay is, in our view, based in large part upon advantages which large corporations have over smaller ones, so that increased levies upon the former would not only be based upon the theory of ability to pay, but would be based upon benefits received." *Ibid.*, p. 217.

stockholders. Since stocks are owned by persons receiving widely different total incomes, corporation income taxes, whether at flat or graduated rates, are not just when used as personal taxes collected at source.

Whether progressive rates are less unjust than flat rates depends on the direction and degree of correlation existing between the size of the total incomes of the stockholders and the size of the incomes of the corporations in which they own stock. Positive correlation would be evidence that the progressive rates are less unjust, negative correlation would be evidence that flat rates are less unjust, and lack of significant correlation would be evidence that no difference in justice as a personal tax exists between the two.

No definite information was found for computing correlation. Common observation indicates that aside from extremely small corporations no significant positive correlation is likely to exist. Because of their marketability the stocks of large corporations are in general more suitable for investors with small incomes than are the stocks of small corporations, while investors with large incomes can diversify their risks among the less marketable and generally more speculative stocks of small corporations. Stockholders in some large corporations are so numerous that many small income receivers must of necessity be among them. For these reasons the writer sees no probability of a significant positive correlation and is of the opinion that progressive rates do not add any element of justice to the corporation income tax as a purely personal tax collected at source.

If the corporation income tax is considered a semi-personal tax in which the one element of an individual's economic position—income from investments—is the measure of justice, progressive rates make the corporation income tax less just than flat rates. Investors in the same economic position so far as income from investments is concerned are treated more unequally under the progressive corporation

income tax than under the flat rate tax. Two persons each receiving $100 from dividends in corporations of different sizes are treated the same under a flat-rate corporation income tax but differently under a graduated rate.

Justice Measured by Ability to Pay

If the corporation income tax is considered an impersonal tax, justice between corporations is dependent on the economic situations of the corporations themselves without reference to their stockholders.

Two common bases for judging justice are ability to pay and benefit. Strictly speaking a corporation has no taxpaying ability. Ability to pay is a characteristic of the total economic situation of natural persons. A corporation has aspects of personality in action, but it has no personality of proprietorship. Its owners are ultimately natural persons. They benefit from its profits and have the ability to pay.

A person may, however, earn a larger return on his investment in one corporation than in another. The corporation producing the larger return may be said to have the greater faculty or ability. The mere fact that the income of a corporation is large in total amount does not mean that it has greater faculty, since the income may have been earned on a large investment. Rate of return on investment, not the size of the income, is significant in measuring faculty.

While admitting that the size of the income as such is no measure of taxpaying ability, some may assert that on the average a larger return on capital is earned in large corporations than in small ones. The truth of the assertion is open to question since both the income and the capital investment figures on which rates of return are computed contain serious sources of inaccuracy. However, the apparent tendency for corporate units to increase in size indicates the probable truth of the assertion. It does not follow as a logical conclusion, however, that all large corporations have

superior faculty. Many large corporations earn low rates on capital invested or suffer loss, while the highest rates of return are commonly earned by small corporations. The advantages said to inhere in corporate size should—if really present—result in a higher rate of return. If corporation faculty is to be measured by income and a graduated rate applied the tax rate should be graduated according to the per cent of return on capital, not according to the absolute size of the income. The graduated excess profits tax rather than the graduated income tax is the way to reach superior faculty.

It may be contended that, while an excess profits tax would be desirable, in the absence of such a tax the progressive income tax may serve as a substitute. The difficulty is that the result is very rough and the injustices among specific corporations both large and small are very great. Many will think them too great.

Justice Measured by Benefits Conferred

It is also maintained that on the basis of benefit tax rates on corporation income should be progressive. If corporations with large incomes receive benefits that are greater in proportion to income earned than are those of corporations with small incomes, progressive rates are justified under the benefit principle of taxation, otherwise not.

An attempt is sometimes made to attribute all income to the benefits of government on the ground that without government the income could not be earned. This is untenable since government is merely one of many essential factors contributing to income. Where benefits are granted to only one or a few concerns, thus conferring monopoly advantage, the benefit of government may be measured roughly by comparing the returns of those receiving the special benefits with returns of other industries generally. Where, however, benefits are granted to all with no favor-

itism it is impossible to measure benefits except by determining the costs that they cause government. This is especially true since competition tends to pass the benefits on to all consumers.

Benefits of government to incorporated business are of two kinds. One includes the general benefits received by all business—peace and order, regulation, highways, markets developed by public education. The governmental costs of rendering such benefits to business apparently are not progressive in relation to net income. Indeed, they do not necessarily bear any relation to net income at all, being more likely to be proportional to gross business transacted or property owned.

The second type of benefit is the corporation franchise. The corporate form is more important, even relative to capital invested, for the large corporation than for the small one. The development of present-day business in large scale units would be quite impossible without the privileges granted in the corporation franchise. This fact gives a possible basis for progressive corporation taxation. It does not follow, however, that large corporations should necessarily be taxed progressively on their income. The corporation franchise is no longer a special privilege granted to a specially favored few. The question of taxing because of benefits through the corporation franchise is not the same as that of taxing the special franchise of monopolistic corporations such as public utilities. Being in economic effect a common right granted because of a belief that thereby the public interest is best served, and being open to all, the benefit of the corporation franchise is perhaps most accurately measured on a cost-caused basis.

Economic Control

The last aim of tax systems to be discussed here is that of economic control. At the bottom of most arguments in

favor of progressive rates is the idea that large corporations are less desirable than small ones. When large corporations thrive better than small ones the proposal to equalize competition through taxation may be couched in terms of tax justice but the real purpose is often to protect the small corporation regardless of tax justice.

If all large corporations are bad, instruments of social control should be used to eliminate them and taxation should be employed if it is effective for the purpose. Few people, however, propose the abolition of all large corporations. The social benefits from large-scale production are recognized as too great. The valid objection is rather to the misuse of economic power by large corporations. First, it is maintained, their economic power may lead to inefficient productive units driving out of business more efficient units. A large corporation can fight financial battles so much better that it may be able to stay in business and dominate the industry even though it may be economically less efficient than smaller corporations. Second, it is maintained, the economic power of large corporations leads to unjust distribution of income and wealth through monopoly prices to consumers, low wages, and low prices to producers.

Much evidence exists of the dangers of the economic power of large corporations. Before concluding, however, that because of these dangers large corporations in general should be penalized by the imposition of progressively heavier taxes, several facts should be considered. The first is that mere size of income is no indication of socially undesirable economic power. A ten million dollar income may represent so small a return on capital as to prove false the conclusion that the corporation has any superior economic power because of size. Economic power is much more likely to be indicated by the rate of return on the investment. A large return on investment continuing over a period of years is evidence of special economic power regardless of the size

of the concern. The second fact—a very important one—is that the size of maximum efficiency as well as the size at which danger is present varies from industry to industry. A concern large enough to exert monopoly power in one industry might be an inefficiently small unit in another. A progressive rate scale adequate to discourage monopoly in an industry of large units may not affect the largest concerns in an industry of small units.

A third factor to be considered is that the tendency of a progressive tax on corporate income would be to discourage large-scale production whether or not it was efficient and to shift production to smaller, less efficient units. This would decrease the efficiency of using labor and resources and consequently would reduce the standard of living.

For these reasons, the conclusion is reached that progressive general corporation income taxation is much too crude an instrument with which to discourage socially undesirable economic power. Classification of industries and adjustments making the tax more nearly a progressive excess profits tax might make it a usable instrument of control.

Unincorporated business income taxes call for little comment. More correlation between the size of the incomes of specific unincorporated businesses and the total incomes of their owners probably exists than in the case of corporations. Since, however, the personal income tax can be used no need exists for using a tax on unincorporated business as a personal tax. The problem of franchise benefits does not arise. The assertion is seldom made that large unincorporated businesses are socially undesirable. To the extent that they are, the same comments apply to taxing them as to taxing socially undesirable corporations.

Summary

To summarize, it appears from the above analysis that progressive tax rates on business income do not decrease

difficulties of administration and may increase them. Such rates would more likely decrease the stability of revenue yield than increase it. They would probably not increase the justice of the business income tax as a personal tax. With the personal income tax available there is no need for a personal tax collected at source. Progressive rates would decrease the justice of the business tax as a semi-personal tax on investment income. Taxpaying ability of corporations is not progressive with mere size of income. The correlation of size of income and rate of return even if it exists has too many exceptions to justify general progressive income taxation as a substitute for excess profits taxation based on ability. Government benefits on a cost-caused basis are not progressive with size of incomes. Although the benefits of incorporation are probably progressive with the size of the corporation, imposing a progressive income tax on this basis is of doubtful propriety when incorporation is open to all. As an instrument of social control the progressive business income tax of the usual type is too crude an instrument to attack socially undesirable bigness. In general the conclusion is accordingly reached that taxation of corporation income is less likely to achieve tax aims at progressive rates than at flat rates.

CHAPTER VII

NEW YORK'S EXPERIENCE WITH A TAX ON UNINCORPORATED BUSINESS

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During the year 1935, the legislature of the State of New York enacted a "tax on unincorporated business." A person unacquainted with the features of this tax might conclude from its title that it is very broad in its application and covers a multiplicity of small businesses of all sorts which for some reason or other do not incorporate, such as stationery stores, drug stores, restaurants, groceries and the like. In reality, the scope of the tax is very narrow. It affects only the larger individual proprietorships and partnerships and, even at that, not all of them.

The law exempts from the tax all professional businesses—law, medicine, dentistry, architecture and the like—and all businesses in which more than 80 per cent of the gross income is derived from personal services rendered by the owner or owners, or in which capital is not a material income-producing factor. Moreover, the law exempts all unincorporated businesses with a net income of less than \$5,000; and it grants an additional exemption from the tax in the form of a permissible deduction from the net income of \$5,000 as salary to the owner, or where there is more than one owner, of a \$5,000 salary to each such part owner in the business.

As a result of these liberal exemptions only businesses earning a net income of more than \$10,000 when owned by a

single individual, more than $15,000 when owned by two partners, and correspondingly larger sums when owned by three or more partners, are subject to the tax. There are relatively few such businesses. It is interesting to note that when the tax was first enacted, the State Department of Taxation sent out circulars to a list of prospective taxpayers, numbering more than 100,000 whose names were taken from a much larger list of some 250,000 individuals and partners engaged in businesses who had filed personal income tax returns with the state. From this list of more than 100,000 prospects, the Department obtained eventually 7,000 actual taxpayers. This is a very small number when compared, for example, with 200,000 corporations paying the corporation taxes in this state. Most of these 7,000 taxpayers are brokers, investment bankers, and similar financial business men.

Some of the businesses receiving exemptions on the ground that they are engaged in a professional or personal service, are substantial engineering, law or accounting firms, employing large staffs of employees and having payrolls of upward of $500,000. Some of the smaller businesses such as drug stores or opticians receive additional exemptions on professional grounds; the income derived from the filling of prescriptions and other services as druggist, for example, is separated from the income derived from his mercantile activity, and the former income is exempted.

When the tax on unincorporated business was originally proposed in 1932, by the New York State Commission for the Revision of the Tax Laws, it was intended to be a broad tax. It was proposed as a means of equalizing the treatment of incorporated businesses and unincorporated ones in the matter of taxation. It was also offered as a substitute for the then existing taxation of the personal property of unincorporated businesses, such as their stock in trade, under the general property tax. It was generally admitted

that the tax on personal property in this and other forms was inequitable and ineffective. In other words, the intention was to cover with this tax a very substantial portion of the unincorporated businesses of the state. The tax was expected to yield \$12,000,000 annually at a then proposed rate of 3½ per cent on the net income and a minimum filing fee of \$10. Actually, the tax yielded during the fiscal year 1936 only \$3,600,000. It is expected to yield for the fiscal year 1937, \$4,000,000.

The tax is levied at the rate of 4 per cent on the net income earned in the state. This rate compares favorably with the present rate of 6 per cent on corporations. It should be noted, however, that this 6 per cent rate is composed of a 4½ per cent regular rate and a 1½ per cent emergency rate. Should the emergency rate of the corporation franchise tax be abandoned, the rate of the unincorporated business tax would probably have to be reduced to 3½ per cent, for there should probably be a spread of at least 1 per cent between the two taxes to allow for the benefits of the corporate form. In case of businesses receiving their income partly from business done outside the state, the proportion of the income earned in the state is determined by the use of the same factors as are used in the case of the corporation franchise tax, namely: the proportion of the concern's total property held in the state, the proportion of its total payroll paid in the state, and the proportion of its total gross sales realized in the state. The allocation of the net income presents the same complications (and possibilities for tax evasion) in the case of the unincorporated business tax as it does in the case of the state corporation franchise tax. A return is required from every business with a gross income of \$10,000 or more, irrespective of whether it earns a net income or not.

The tax is collected together with the personal income tax on the same returns. Great savings in its collection

are effected thereby. Its collection requires, however, somewhat more extensive auditing and field investigation than does the personal income tax. It is estimated that the cost of collecting it amounted the first year to approximately 5 per cent. The tax appears to be practicable. It should be noted, however, that it was enacted as an emergency tax and will expire during the next year (1937), unless it is re-enacted.

The tax should probably be made permanent. But if it is made permanent, it should be broadened considerably at the same time. Yet it should not be made so broad as to be difficult of administration. It would suffice to reduce the exemptions of net income from \$5,000 to \$2,500 and also to reduce the deductions from the net income for salaries received by the owners from \$5,000 for each owner or partner to \$2,500 for each owner or partner. Even on this basis the tax would reach only the businesses with net incomes in excess of \$5,000 in the case of one owner, \$7,500 in the case of two owners, and only those with correspondingly higher net incomes, in the case of businesses owned by several partners. The average mercantile business will not be reached even under a tax broadened in this manner.

CHAPTER VIII

THE TAXATION OF UNDISTRIBUTED PROFITS FROM THE BUSINESS POINT OF VIEW

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I WOULD be delighted if I could speak for "business." Unfortunately, however, I have no authority. Accordingly, my remarks upon the "Taxation of Undistributed Profits from the Business Point of View" do not reflect the views of business generally or of any business specifically. Nevertheless, I consider it a distinct privilege to appear before you and present my personal views.

ORIGIN OF THE UNDISTRIBUTED PROFITS TAX

Approximately one year ago, the undistributed profits tax system was recommended, for the declared purpose of:

(*a*) Correcting "the existing differences between corporate taxes and those imposed on owners of unincorporated businesses";
(*b*) Seeking "equality of tax burden on all corporate income, whether distributed or withheld," and thus preventing evasion of surtaxes through the "accumulation of surplus in corporations"; and
(*c*) Effecting "great simplification in tax procedure." (See, *Message from the President*, March 3, 1936.)

The system was proposed as a substitute for the existing corporate income, excess profits, and capital stock taxes. All three of these taxes, however, are still in existence. As finally enacted, the undistributed profits tax, in broad outline, includes:

(*a*) The imposition of a so-called normal tax upon the "net income" of corporations, graduated up to 15 per cent;

(*b*) The imposition of a so-called surtax on undistributed profits, graduated from 7 per cent to 27 per cent, upon the "undistributed net income" of a corporation;

(*c*) The taxation to the corporation, at normal tax rates, of 15 per cent of the dividends received from domestic corporations;

(*d*) The inclusion, for purposes of the undistributed profits surtax, of 100 per cent of the amounts received as dividends from domestic corporations; and

(*e*) The subjection of all dividends distributed to individuals to the normal tax of 4 per cent.

So much for the origins and basic provisions of the so-called undistributed profits tax.

It seems to be generally assumed in Washington that these principles have become a part of our permanent revenue system. Upon this assumption, our efforts should be directed toward the formulation and adoption of desirable or necessary amendments.

The Tax Policy League, however, is not irrevocably bound by the decisions of Washington. It is your pleasurable duty to review existing and proposed tax policies, from time to time, and, after an impartial, independent, and non-political examination and analysis, to determine, in the light of all the facts available to you and under the circumstances existing during any particular period of time, whether any policy should remain or become a permanent policy. It seems appropriate, therefore, for me to disregard for the present the policies of Washington; and for me to attempt to present an analysis which may assist you in reaching your independent conclusions.

The Business Point of View

I find it practically impossible to draw a distinguishing line between the "business" point of view and the "public" point of view. After all, substantially all of us are dependent upon business for our livelihood, whether we be "rich

man, poor man, beggar-man, thief, doctor, lawyer, merchant, chief." And substantially all the revenues of our governments are derived, directly or indirectly, from the income of our business activities, past, present, or future.

I suggest that the first approach be to ascertain the views which each of you personally would hold if you occupied any one of the innumerable places in the business world—whether it be as a contributor of capital or a contributor of services; whether your activities are carried on as a corporation, an association, a joint-stock company, a business trust, a partnership, or an individual; and whether your business be monopolistic or highly competitive; "big" or "little"; sufficiently powerful to fix prices, or forced to follow prices fixed by others; financially strong, or financially weak; well established, or comparatively new; possessing opportunities for growth and expansion, or handicapped and restricted; engaged in long-term or short-term production; handling a "slow-moving" or a "quick-turn-over" product; an enterprise the profits of which can be measured by its activities over a one-year period, or an undertaking which requires a period of years in order fairly to measure its true income; a cash or a credit business; a business engaged in the production of capital goods or in the production of consumers' goods; a public utility, or a private enterprise; a buyer, seller, or consumer; a business having a large number, or a relatively few, participants; an undertaking requiring substantial investments, or a business in which capital is a relatively unimportant income-producing factor; a business possessing a reasonably assured income, or a more hazardous enterprise; a business which requires credit, or one which has ample available funds; an undertaking carried on through a group of affiliated corporations, or through one corporation; a business operating solely for the public good, such as an educational or charitable institution, or a business operating primarily for the benefit of its participants, al-

though, as is usually the case, it promotes the general welfare and the public is benefited; a bank, trust company, insurance company, or investment trust; whether you are working for someone, or are dependent upon your own resources and abilities; and whether you are interested in the welfare of labor, including the relief of unemployment. And, perchance, you might approach the problems as one engaged in the business of running the government.

Obviously, no one person is qualified to discuss the consequences of a tax upon undistributed profits from each of the above points of view. But there must be a few general principles which you can adopt and apply to the infinite number of enterprises, placing yourselves in the position of the executive, a member of the board of directors, a comptroller, a treasurer, an auditor, a lawyer, a stockholder, an official, an employee, a laborer, a creditor, or a debtor, whether your capacity is a present or a future one. It is only after such considerations, among many others, that the problems and effects of the "taxation of undistributed profits from the business point of view" can be appreciated.

Suggested Principles

With such varied, divergent, conflicting, and entangled interests, it would seem to me that you might first attempt to agree upon a few general principles of possible application. I realize, perhaps too well, that an acknowledgement or a recognition of their violation might be the only consequence of such a determination. I also readily admit that general principles agreed upon today might be inapplicable tomorrow. Nevertheless, I am confident that you will not cease your constant search for and determination of basic principles.

I am leaving a few suggestions for your consideration. Upon you, however, rests the responsibility of acceptance or rejection. And certainly I shall not trespass upon your

second function—the duty of determining whether the existing tax upon undistributed profits is consistent with the principles you adopt.

It seems to me that a tax—

1. Should impose liabilities reasonably certain of ascertainment;
2. Should not impose unreasonable or excessive burdens;
3. Should not discriminate too harshly among competitors, giving to some advantages denied to others;
4. Should apply with reasonable equality to all classes of business, whether or not competitive, imposing substantially equivalent burdens upon all types of business profits;
5. Should not be open to excessive avoidance;
6. Should not unduly interfere with normal business transactions;
7. Should be reasonably coordinated with other revenue measures, whether Federal, state, or local;
8. Should tend to produce the results for which imposed, whether they be for the raising of revenues, for the prevention of improper practices, or for so-called "social" purposes;
9. Should not conflict too severely with other governmental policies; and
10. Should be capable of reasonably sound administration, including a final determination of liabilities without undue delay.

I realize fully that one or more of the above principles may not be acceptable as basic in the field of Federal taxation. To those to whom the suggested principles are not acceptable, I extend an urgent and sincere request to submit replacements, additions, and betterments.

I am much more interested in assisting in the evolution of satisfactory principles which will guide future legislation than I am in being the dictator of them.

Application of Suggested Principles

I realize, also, that there will be disagreement as to the effect of the application of these principles to the undistributed profits tax. I wish merely to present my viewpoint of the law, based on typical situations arising under it.

1. *Reasonable Certainty.*

Despite its obvious lack of simplicity, I would be quite content if this new tax statute, irrespective of its complexity, afforded reasonable certainty in determining tax liabilities under it. Judged, then, by this standard, how does the undistributed profits tax fare?

The present law and the regulations prescribed under it require a determination *before the end of the year* of—

(*a*) The earnings and profits for the taxable year, those accumulated since February 28, 1913, and those accumulated prior thereto;

(*b*) The gross income, the allowable deductions, the net income, the available credits, and the adjusted net income for the year;

(*c*) The amount of taxable dividends paid during the year and actually received by the stockholders prior to the end of the year; and

(*d*) The "undistributed net income" for the year, including the existence and amount of certain possible credits.

It is my opinion that, in substantially every case, none of these determinations is possible before the end of the year and can not be determined with reasonable certainty even after the close of the year. The following indicates a few of the many difficulties involved in these necessary computations.

Earnings and profits.—The ascertainment of the corporation's earnings and profits is a primary determination for purposes of the undistributed profits tax. Yet five different computations of earnings and profits may be necessary:

(*a*) The earnings and profits of the taxable year, in order to determine the "dividends paid" credit which operates to reduce the undistributed profits tax.

(*b*) The earnings and profits accumulated since February 28, 1913, in order to determine, in the case of ordinary distributions, the amount of the "dividends paid" credit and, in the case of a distribution in liquidation, the amount properly chargeable to earnings and profits.

(*c*) The earnings and profits for the taxable year and accumulated since February 28, 1913, as specially defined for purposes of

contracts restricting the payment of dividends under section 26(c) of the Act.

(*d*) The earnings and profits of a wholly-owned subsidiary corporation, for the taxable year, and accumulated since February 28, 1913, in the case of the liquidation of such subsidiary by the parent, in order to compute the "dividends paid" credit allowable to the subsidiary for its income prior to liquidation.

(*e*) The earnings and profits devoted to specified purposes in the case of bank affiliates or national mortgage associations, in order to compute a special credit allowed to those corporations under section 26(d) and (e).

The problems involved in the computation of the several kinds of earnings and profits are innumerable. There is no fixed or statutory set of rules for determining earnings and profits. Rather, they are computed, presumably, in accordance with acceptable business practices and sound accounting principles. The acceptability of these business practices or accounting principles has been and still is the subject of constant dispute between the Bureau and the taxpayers.

Adjusted net income.—In order to determine adjusted net income, the corporation must first compute its net income for the year.

But the determination of net income was the basis for computing the corporate tax in the past, and was and still is the source of practically all the disputes and litigation between corporate taxpayers and the government in prior years. The Treasury regulations are innumerable, and frequently revised. Thousands of cases are referred to the General Counsel's office; several thousand deficiency letters are mailed each year; and thousands of cases are filed with the Board of Tax Appeals and the courts. The Board and the courts frequently override the Treasury regulations and decisions; and the Commissioner loses a substantial percentage of the cases in litigation.

If the Commissioner can not determine the taxable net income of the corporation after years of consideration, how

can the corporation be expected to compute its net income with accuracy even if a reasonable time were provided?

And, now, in addition to the determination of net income which afforded so much controversy and litigation in prior years, the corporation must make a host of new determinations, involving the computation of adjusted net income and undistributed net income.

Dividends paid.—The determination of the amount of taxable dividends paid has now become a very complicated problem. The first inquiry must be, "Is the dividend taxable?"—a question to which frequently a reliable answer can not be given. Again, the fair market value of the property must now be determined before the end of the year, in the case of a dividend paid in kind, or in obligations of the corporation, or in stock or stock rights of the corporation. But the computation of the fair market price, especially in the case of unlisted securities, can not be made with any assurance of accuracy or of acceptability to the Bureau. Furthermore, the dividends must actually be received by the stockholder before the end of the year. A corporation whose stock is widely held can not possibly ascertain this fact.

Undistributed net income.—In addition to determining gross income, net income, and adjusted net income, with the intermediate deductions and credits, a corporation must finally determine its undistributed net income. This is an entirely new tax concept, and the statutory provisions are ambiguous and uninterpreted.

I have given you a picture of only a few of the complexities of the determinations required under the present law of separate corporations. Consider next their application to consolidated or affiliated groups, where each corporation in the group must make its separate computations and every distribution must pass through all the corporations to the ultimate noncorporate stockholders before the penalty tax is avoided. You will then have some idea of the impossible

problems confronting the corporate taxpayer under the present law.

As for "certainty," I conclude: If our principle of "reasonable certainty of tax liability" had been applied, *certainly* the undistributed profits tax would have been neither advocated nor enacted.

2. *Unreasonable and Excessive Burdens.*

It has been customary to apply two tests in determining whether a proposed tax would impose a reasonable and fair burden: (*a*) Does the tax conform to the principle of ability to pay; and (*b*) has the tax a reasonable relation to benefits received? In the entire legislative proceedings leading up to the enactment of the undistributed profits tax, the second test—benefits received—was never mentioned. I ask merely in passing, is it appropriate to discard the benefits received doctrine, as one of the measures of a fair and reasonable tax burden? Should our tax contributions to our government be based solely upon our ability to pay?

For present purposes, however, I am willing to rest upon the first test. Let us weigh the reasonableness of the new tax burdens solely by the test of ability to pay.

I remind you that we are now imposing a normal tax upon corporate net income of approximately 15 per cent; and additional penalties, based upon the amount of that income which is not distributed during the taxable year in the form of taxable dividends to the stockholders. It is self-evident that every corporation will attempt to avoid the penalty, unless, for some reason, it is unable to declare and pay taxable dividends, unless honest mistakes are made, or unless it is poorly advised.

Is a penalty graduated up to 27 per cent in consonance with ability to pay—

(*a*) In the case of a corporation prohibited by law from declaring dividends;

(*b*) In the case of a corporation prohibited by contract from declaring dividends—such as contracts for the amortization of debt or the retirement of outstanding stock;

(*c*) In the case of a corporation prohibited by sound business judgment from declaring dividends?

To me the corporation best able to distribute earnings probably has the highest degree of ability to pay, while the corporation compelled to retain earnings in the face of the terrific penalty is less able to stand the burden. By what strange logic does the amount *retained* measure ability to pay?

There are countless instances in which a corporation will be compelled to pay from 50 to 200 per cent or more of its annual profits in taxes to the Federal Government by reason of the differences between its arbitrarily defined "net income," "adjusted net income," or "undistributed net income" and its true or book profits out of which dividends are payable. Can the exaction of more than real annual income be justified on the theory of ability to pay, or by any other test?

Let me ask further—

Is it fair and reasonable to impose a normal tax upon the income of a corporation and to impose a second normal tax upon that income when distributed to the stockholder?

Is it fair and reasonable to impose a penalty of approximately 27 per cent upon retained profits and then to tax again these same profits when subsequently distributed?

Is it fair and reasonable to impose a tax upon the income of a corporation, and to tax a portion of that income again when distributed to another corporation?

Double, triple, and multiple taxation require a more convincing justification than has yet been offered.

3. *Discrimination Among Competitors.*

Let me now discuss the effect of the new tax law upon competitors, placed in the following typical situations:

(*a*) One is a resident foreign corporation subject only to a 22 per cent tax; the other is a domestic corporation and subject to the undistributed profits tax.

(*b*) One has been in receivership during the taxable year, and therefore pays only the normal or 15 per cent tax; the other has escaped receivership and is subject to the penalty.

(*c*) One is burdened with debt and the other fortunately free of debt.

(*d*) One has adequate funds and can finance replacements, improvements, additions and betterments; the other must finance such expenditures by borrowing.

(*e*) One has an adequate, up-to-date, efficient plant; the other requires new machinery and improved facilities.

(*f*) One has stockholders willing and able to contribute additional funds; the other must rely upon borrowing.

(*g*) One has impaired its capital by reason of losses during the depression, and under the laws of the state of its organization it is prohibited from declaring dividends; the other is legally free to declare dividends and avoid the penalty.

(*h*) One has that rare written contract which meets the narrow and highly technical provisions in the statute with respect to the payment of a debt; the other has precisely the same amount of debt outstanding which requires precisely the same amortization but the debt does not come within the statutory exception.

Similar instances are innumerable. In each, however, one competitor will be taxed, upon precisely the same amount of income, at much lower rates and in much lesser amounts than the other. And you will find that in every case the burden falls much more heavily upon the one less able to pay.

The newly organized corporation, owned and operated by "youngsters" daring to compete with the strong and powerful, must wonder at the wisdom of their government, when they finally awaken to the excessive burden placed upon them. I still seek a justification, either theoretical or practical, for this result.

Unless we are to countenance unfair and unjustified discriminations among competitors, we must condemn the new system.

4. *Equality Among All Classes of Business.*

I call your attention to the fact that banks, insurance companies and foreign corporations are not subject to the undistributed profits tax; and that special treatment in the imposition of the tax is accorded mutual investment companies (as defined in section 48(e)) and common trust funds (as defined in section 169). In other words, your government is taxing the profits of banks and insurance companies at lower rates than the profits of other business enterprises.

Do not misunderstand me. I do not recommend that the penalty be imposed upon banks and insurance companies. Quite the contrary. The day the new system was recommended I stated that obviously a penalty can not be imposed upon banks and insurance companies required by law and sound business practice to add to their surplus annually from their current profits. But if the new system can not apply to them, it should not apply to the others.

But the inequality does not stop there. Professor Crum of Harvard University has recently studied the percentage of earnings paid as dividends over a period of years in the various industrial classifications. As thus classified, he concludes that certain industries like public utilities, petroleum refining, mining divisions, and the metal groups customarily distribute amounts equal to or in excess of their current earnings. Accordingly, the undistributed profits penalty does not apply. Other groups, with slow turnovers or frequent fluctuations in the demand for their product, are fundamentally unsuited to making current distributions in every year. Their true incomes can not be measured by the results of one year's operation. It is upon them that the penalty falls with unjustified severity.

Under the principle I have suggested, we should impose substantially equivalent burdens upon all types of business profits, whether or not the businesses are competitive. Do we discard the principle, or discard the tax?

5. *Excessive Avoidance.*

It hardly behooves me to suggest methods by which the undistributed profits tax may be avoided by the taxpayer. For years I have participated in the fight to prevent avoidance. But never has the inducement for tax avoidance been so strong. The rewards are substantial within the confines of the law. The avenues are broad and inviting. They will be well-traveled.

6. *Undue Interference with Business.*

In the past the amount of tax involved may have been one of the factors taken into consideration in determining a course of business conduct. But the government has been an ardent crusader for the establishment of the principle that tax considerations should not be the sole and motivating force for the adoption of a particular course of business conduct.

Yet now we find the government advocating and enacting a tax which has for its avowed purpose, the adoption of a course of business conduct—i.e., the distribution of corporate earnings—in order to avoid the imposition of the tax. Normally, the corporation's board of directors in determining the extent to which they may legally declare dividends, will take into account—

(*a*) The amount of available cash;
(*b*) The outstanding indebtedness which should be retired, in whole or in part;
(*c*) Maintenance of the proper ratio of current assets to current liabilities;
(*d*) Business prospects for the immediate future, and probable hazards;
(*e*) Reasonable reserves to meet probable contingencies;
(*f*) Necessity for repairs, replacements, betterments, additions and expansions, and the available methods for financing them;
(*g*) Additions to reserves for uninsurable risks, such as losses by floods, explosions, and the like; and
(*h*) Appropriate reserves for preferred dividends.

But now, the primary consideration in determining the course of conduct is the effect upon tax liabilities. Officers, accountants, attorneys, experts devote their days to tax computations "if we do" and tax computations "if we don't." And heavy, heavy hangs over the head of him who fails to be governed by tax consequences. Sound business policy can be given little or no consideration.

7. *Coordination with Other Revenue Provisions.*

Time permits merely an enumeration of a few of many inconsistencies and actual conflicts between the undistributed profits tax and other revenue measures:

(*a*) The original conception of the undistributed profits tax was that it would be in lieu of all other corporate taxes. As finally enacted, however, the Revenue Act of 1936 still contains the corporate normal tax, the capital stock and excess profits taxes.

(*b*) In imposing a "normal" tax at reasonable rates, we can perhaps overlook arbitrary definitions, the taxing of unreal and nonexistent gains, the arbitrary denial of deductions. But when we are imposing *penalties* for failure to distribute annual profits, we should expect the penalty to be based upon "undistributed profits" rather than upon "undistributed net income." A volume would be inadequate to point out the differences appropriately.

(*c*) The principle of taxing accumulated earnings is hardly consistent with the provisions of the present law relating to the taxation of capital gains. Retained earnings (which tend to create appreciation in the value of stock) are subject to the undistributed profits tax, and the same appreciation is also taxed under the capital gains provision upon the sale of the stock.

(*d*) Estate and gift taxes are intended to reach the appreciation in the value of property which has not been previously subjected to income tax. If the retention of earnings is subject to the undistributed profits tax, and the appreciation in the value of property (which results from the retention of such earnings) is also subject to the gift or estate taxes, another duplication of taxation results.

I could not undertake to enumerate the conflicts and inconsistencies with state and local tax laws.

8. *The Purposes of the Tax.*

As I have stated, the declared purposes of the tax were (*a*) to bring about simplicity in our tax system; (*b*) to equalize tax burdens, particularly of corporations, partnerships, and individuals; and (*c*) to prevent avoidance of taxes.

It was demonstrated, I think conclusively, at the hearings before the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the United States Senate that the undistributed profits tax fails completely to accomplish any of the desired ends.

How can anyone claim that simplicity results from retaining, unsimplified, a most complicated tax system, and superimposing upon it another most complicated tax system?

And in what respect were tax burdens equalized by the enactment of this law? Let me again remind you that the alleged inequalities in the old tax system were as follows:

(*a*) "Small" corporations were taxed at higher rates than similar-sized unincorporated groups. The undistributed profits tax was to equalize the tax burden between these classes of taxpayers and thus permit a small partnership to avail itself of the benefits of incorporation without the accompanying excessive tax liability. But has "equality" been obtained by doubling the probable and potential taxes of the small corporation and its stockholders?

(*b*) The former method of taxation was said to result in discrimination against the large partnership as compared with the similar-sized corporation, since the earnings of the large partnership were taxed at the high individual surtax rates applicable to its members, while the earnings of the large corporation were taxed at the flat corporate rate. This alleged inequality never caused me undue concern, since the large partnership could always remedy it by the simple process of incorporation, or, if it was engaged in rendering "personal services" which prevented incorporation, it was not in competition with business corporations. If any inequality did exist, however, it has not been remedied by increasing the potential rates of taxation. If the partnership is rendering personal services, why not decrease its burdens by a reasonable "earned income" provision?

(*c*) The old corporate taxes, it was said, resulted in inequality between the stockholders in the low-income brackets and those in the high brackets, since both were taxed at the same rate upon

corporate earnings irrespective of their respective abilities to pay. The undistributed profits tax was supposed to remedy this situation by enforced distribution of income. The present "normal" tax, however, imposes at least as heavy a burden on the small stockholder as did the former law, and the undistributed profits surtax adds to his burden. Thus, the disparity between small and large stockholders has been intensified.

How can it be claimed, therefore, that tax burdens have been equalized by an increase in the rates of tax, by the imposition of penalties frequently beyond the control of the taxpayer and by the accentuation of existing discriminations?

The only tax avoidance alleged to exist under the prior law was the retention of earnings by corporations in order to protect wealthy stockholders from high individual surtax rates. But large corporations with widely-held securities do not determine dividend policies according to the wishes of their wealthy stockholders. The dividend history of such corporations, as revealed by the Treasury Department's *Statistics of Income*, bears out this fact. The evil was grossly exaggerated. Moreover, there were already on the statute books two provisions designed to remedy the possibilities of avoidance from this source—

(*a*) The provision applicable to all corporations formed or availed of for purposes of preventing the imposition of surtaxes upon stockholders through accumulation of earnings or profits; and

(*b*) The provision applicable to personal holding companies—i.e., closely-held corporations which accomplish the same end for their stockholders.

If either of these provisions was ineffective to prevent tax avoidance, the proper remedy was to improve them by further amendment. Instead, a punitive measure of the broadest possible application was adopted to remedy an abuse, admittedly practiced by a comparatively insignificant number of corporations. Was it necessary to fire a shotgun into the crowd to kill the culprits?

9. *Conflict with Other Governmental Policies.*

I think it is fairly well recognized that our present Administration is determined, among other things—

(*a*) To suppress monopolies;
(*b*) To insist upon sound financing of business;
(*c*) To bring about a small income yield for capital and a greater return for personal services;
(*d*) To encourage the reemployment of its present unemployed;
(*e*) To create greater opportunities for youth; and
(*f*) To provide security for the aged.

One need only to enumerate the above policies to realize that the tax upon undistributed profits is in direct conflict with each of them.

For example, if I were in possession of a monopoly which I wished to perpetuate, or if I wished to create a monopoly and were merely awaiting tempting opportunities, I would praise the undistributed profits tax. I would know that new competitors in the field were unlikely; that my smaller and weaker competitors could not grow; and that "bargains" would soon appear at the industrial counter.

With respect to the sound financing of business, consider the requirements of certain governmental lending agencies, such as the Reconstruction Finance Corporation and the Rural Electrification Administration, insisting upon the retention of corporate earnings. Certainly, this policy is diametrically opposed to that upon which the undistributed profits tax is based. If any further evidence of policy conflicts is required, I need only refer you to the Annual Report of the Interstate Commerce Commission and to a recent article by Joseph Kennedy. The Interstate Commerce Commission states that, as a result of the undistributed profits tax—

(*a*) A conflict will arise between the requirements of the Commission for sinking fund reserves and the penalties imposed by the tax for failure to distribute;

(*b*) Companies which have weak financial structures and should use their income to improve property, retire funded debt and build up protective surpluses, will be penalized by the tax for taking these necessary precautions; and

(*c*) The inequality between the strong and the weak roads will be accentuated by the tax.

Mr. Kennedy, former chairman of the Securities and Exchange Commission, and one of the staunchest defenders of the present Administration, points out that a revision of the undistributed profits tax principle in our Federal revenue legislation is necessary because—

(*a*) Corporations able to accumulate surplus in prosperous years were thereby enabled to continue operations and the payment of dividends during the depression period, despite substantial operating deficits.

(*b*) If business distributes earnings as contemplated by the undistributed profits tax, it will not be adequately prepared to weather any future depression.

(*c*) The tax disturbs the continuous flow of dividends and accentuates, in the hands of investors, the peaks and depressions of business, thereby inflicting injury upon those who depend on the continuity of dividend payments for current living expenses.

(*d*) The few instances of excessive corporate hoarding or expansion of plant are not sufficient justification for a tax which adversely affects all business corporations.

(*e*) The tax penalizes the small and new concern which has not developed sufficiently to accumulate adequate surplus.

Industry has been told that it must assume responsibility for the employment of the unemployed. Concurrently, through the undistributed profits tax, our government—

(*a*) Imposes a penalty upon the use of current earnings for expansion of plant, replacement and improvement of facilities, and development of properties;

(*b*) Increases the hazards of carrying on business;

(*c*) Discourages, almost to the point of prohibition, the establishment of new enterprises; and

(*d*) Paves and shortens the road toward the next depression.

10. *Administration.*

It has always been my position that our tax laws should be capable of administration so that—

(*a*) The costs, delays, and risks of litigation may be avoided;
(*b*) The costs of expert advice may be maintained at a minimum—for, after all, they merely add to the tax burden;
(*c*) Final determinations, binding upon both the government and the taxpayer, may be made without undue delay, and additional assessments five, ten, or even fifteen years after the close of the year involved, may be avoided;
(*d*) Changes in regulations will not be applied retroactively to increase tax liabilities;
(*e*) Final decisions of our judicial tribunals will be accepted and applied;
(*f*) Adverse changes in rulings will not be made unless compelled by court decisions; and
(*g*) Advisory opinions binding upon the Treasury will be readily available to taxpayers.

The new law certainly does not promote the above objectives. Quite the contrary. The complexities, uncertainties, conflicting provisions, and ambiguities of the new law must necessarily force us in the opposite direction. And, in discussing administration, it seems appropriate for me to express my highest respect for the honesty and ability of the officials and their staffs upon whom the duty and responsibility are now imposed.

Defense of the New System

Those who defend the new system state that the inequalities, discriminations and severities of the law do not in fact exist, for they may either be mitigated by the so-called relief provisions, or avoided entirely by such devices as the payment of a dividend in scrip, the issuance of additional stock which will be taxable in the hands of the stockholders, or by contracts under which the stockholders will recontribute the dividend to the corporation. These are the only defenses of the law I have heard. Let me analyze them more carefully.

1. *Relief Provisions.*—There are two so-called relief provisions, presumably intended to prevent the imposition of the penalty in cases where the payment of dividends was prohibited by contract or where a portion of the earnings and profits of the year was required to be set aside for the discharge of a debt. The necessity for relief was apparent and seemed to be readily admitted. The provisions as actually enacted and as construed by the Treasury, however, merely bring into bold relief the unreasonableness of the tax and the discriminations created by it.

Although the actual situations are innumerable, at least four provisions are typical:

(*a*) The sinking fund provisions of a bond issue frequently require the setting aside of amounts for the amortization of the debt. The amount to be set aside may be specified, may be a percentage of the current year's earnings, or may be proportionate to dividend payments. Although in each such instance the corporation is actually prohibited from the payment of dividends, the statute grants relief only if the provision *expressly* deals with the payment of dividends, only if the written contract was executed by the corporation *prior* to May 1, 1936, and only if the provision prohibits the payment of dividends in *all* forms, both stock and cash. The penalty will be imposed in all other cases. I confidently predict that not one contract in a thousand will comply with the statute. Furthermore, in the rare case where a corporation is fortunate enough to have a contract which fits these requirements, the refunding or renewal of the contract in identical terms *after* May 1, 1936 will deprive the corporation of its credit.

(*b*) The provisions of a preferred stock issue often require the annual retirement of a certain amount of the issue. Even though the provision specifies the percentage of earnings and profits to be devoted to retirement, the provision is deemed not to comply with the statute, and no relief is granted.

(*c*) It is very commonly provided that the corporation must maintain a fixed ratio of quick assets to current liabilities. One of the most effective and practical methods of maintaining this ratio is to accumulate earnings and profits, and to follow a reasonably conservative course in the payment of dividends. Nevertheless, a provision of this character does not meet the hypertechnical provisions of the new law.

(*d*) A corporation, either because of written contracts, express or verbal understandings, or accepted business practice, fre-

quently is unable to pay dividends until all accrued interest and a reasonable amortization of an outstanding debt has been paid. This corporation likewise must pay a penalty.

What effect will the new tax system have upon refinancing and upon bank credits? And what is the added cost to the corporation of borrowed money?

2. *Dividend Devices.*—As I indicated above, it has been suggested that the severity of the tax may be avoided entirely if there is issued a dividend in scrip or in stock which is taxable to the stockholder or if a cash dividend is paid coupled with an attractive right to purchase additional stock.

Those who urge these methods have had little or no practical experience in the financing of corporations or in the issuance of corporate securities.

I am not interested particularly in the so-called "big fellow." He either has adequate funds, adequate credit, or ready access to the investment market. His securities have a readily ascertainable market value. Rather, let us consider the situation of the "little fellow"—the corporation said to benefit by the law.

I discard the issuance of "scrip," for the determination of its value (and frequently it may have no value) is impossible; and, in addition, it merely postpones the evil day.

So let us assume that he decides to issue preferred stock. The following problems immediately arise: He must first obtain the consent of his existing stockholders. He must pay the costs and expenses. He must plan to have adequate time for charter amendments or registration of the stock. He must disregard the possibility of over-capitalization. He must determine the value of the preferred stock on the date of its issuance, with absolute accuracy. And having done all this, he may then find that the dividend is not taxable in the hands of his stockholders and that the penalty must still be paid.

To those who favor the payment of cash with an attractive right to recontribute, I reply that they do not know the reluctance of stockholders to part with cash, nor have they ever been confronted with the problem of dissenting minority stockholders.

Let us now look at the situation from the point of view of the stockholder. If he is forced to accept a piece of paper in lieu of a cash dividend, he may be compelled to sell the piece of paper in order to pay his tax, and his interest in the corporation is correspondingly diluted. A mass of statutory law and of court decisions has been developed to protect him against dilution and to afford him every opportunity to maintain his proportionate interest in the corporation. What now becomes of the protection heretofore afforded him by law?

Finally, consider the situation of the director of our small corporation. He knows that a dividend should not be paid either by the exercise of sound discretion or by reference to a state law forbidding such a payment out of impaired capital. Yet he realizes that his corporation faces a severe penalty unless a dividend is paid. Consider his possible liabilities if, under these circumstances, he votes in favor of a dividend. And then consider his possible liabilities if he permits the corporation to incur the penalty.

Conclusions

There was some justification, in academic theory, for the undistributed profits tax system as originally recommended by the President and the Treasury. In the course of consideration by the Congress, however, academic theories were mingled with a flood of practical considerations. The hybrid character of the ultimate product must be recognized. The law as enacted has failed to accomplish any of the purposes for which it was proposed. It violates each of the

fundamental principles I have suggested, and every other known principle of taxation with which I am familiar.

It should not remain a part of our permanent revenue system. It should be repealed at once and *in toto*.

Recommendations

Upon the assumption, however, that the undistributed profits tax system is to remain with us for some time to come, every effort should be made to remove as many of its inequalities as possible and to make it as workable as possible. To this end, I recommend:

1. The base of the tax should be made to conform as nearly as possible to "book income," as distinguished from the arbitrary statutory definition of "undistributed net income."
2. Provision should be made for the carrying forward of business losses for several years.
3. Adequate and sensible relief should be afforded the corporation with impaired capital, the corporation having outstanding debts, and the corporation having contracts prohibiting the payment of dividends.
4. Expenditures for improvements, additions, betterments, replacements, expansion and development should be permitted without the imposition of a penalty.
5. The requirement that taxable dividends must be declared and paid before the end of the taxable year is not necessary. A provision allowing credit for dividends declared and paid prior to the date for filing the return should be substituted, together with a provision allowing credit for dividends paid within three months after the final determination of the corporation's "undistributed net income," in every case in which the net income as shown on the return is increased.

Amendments to carry out these recommendations should be adopted at this session of Congress, and many of them should be made retroactive. Their cost in immediate revenues is relatively insignificant, and ultimately they will result in increased revenues. The necessity for them is paramount.

CHAPTER IX

THE TAXATION OF UNDISTRIBUTED PROFITS FROM THE POINT OF VIEW OF THE FEDERAL TAX STRUCTURE

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I am very glad to be here, on the invitation of the program committee of the Tax Policy League, to discuss the taxation of undistributed profits from the point of view of the Federal tax structure. It is not my purpose to defend or to criticize the detailed provisions of the Revenue Act of 1936. Rather, I shall attempt to review with you the background of this act and its place in the Federal tax structure.

It is principally related, of course, to our system of individual and corporate income taxes; and the central position occupied by income taxes in the Federal revenue structure is perhaps sufficiently illustrated by the fact that receipts from income and profits taxes have constituted not far from one-half of the aggregate receipts of the Federal Government during the last fifteen years. It is the income tax, moreover, which supplies the principal progressive element in our tax structure.

History of Federal Income Tax

Income taxes in this country have had a long and checkered career. They go back to the time of the Civil War when increased expenditures by the Federal Government necessitated new sources of revenue. Prior to that time the

revenue needs of the Federal Government were small and were mainly met by customs duties. The few internal revenue taxes that had been in force intermittently were largely abolished by 1818. Except during a few periods of business depression, and during the War of 1812, the Florida War, and the Mexican War, Federal receipts usually exceeded Federal expenditures. The national debt, in fact, was extinguished in 1835—though the depression that followed the panic of 1837 and the Florida War and the Mexican War quickly created a new national debt.

The impact of the Civil War greatly increased the financial requirements of the Federal Government; and among the various revenue measures adopted by Congress was the imposition for the first time of income taxes. A total of approximately $376,000,000 was collected from income taxes as a result of the Civil War revenue measures and their subsequent modifications. These early Federal income tax laws expired by limitation in 1872.

Twenty-two years later, during President Cleveland's second administration, a Federal income tax law was again enacted. This Act of 1894, as is well known, was held unconstitutional in May of the following year by a five to four decision of the United States Supreme Court on the ground that the tax was a direct tax and the Constitution required all direct taxes to be apportioned among the several States in accordance with their population. The constitutionality of the Civil War income taxes had been previously upheld on the ground that they were indirect taxes.

In 1909, fourteen years after the Supreme Court's adverse decision, Congress enacted what was termed an excise tax on corporations, the tax, however, being fixed at 1 per cent of the net income of a corporation after a $5,000 exemption; and the constitutionality of this Act was upheld by the United States Supreme Court. In order to remove the constitutional objection to a direct Federal income tax

as such, Congress, on July 12, 1909, passed a joint resolution proposing the Sixteenth Amendment, which was declared ratified by the States on February 25, 1913, the Amendment reading as follows:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The first of what may be termed the present series of Federal income tax laws, enacted under this Amendment, was signed by President Woodrow Wilson on October 3, 1913, to take effect as of March 1 of that year.

Problem of Corporation Income

Throughout our experience of the past 23 years with income tax legislation and administration, the most difficult problem that we have encountered—next to the definition of income itself—has been the problem of the proper tax treatment of corporation income. There is one body of opinion that has held that business organizations generally, whether incorporated or not, may be properly subjected to special rates or forms of taxation. There is another body of opinion that has held that corporations, because of the valuable special privileges granted to them by law, may be properly taxed more heavily than other forms of business organization. And there is a third body of opinion which has held that corporations, like other business organizations, are merely conduits through which income flows to individuals and that the taxation of corporation incomes as such is therefore unjustified, since it involves double taxation—first, when the income taxes are paid by the corporation, and second, when the stockholders pay individual income taxes on their dividend receipts.

In the Civil War income tax measures, no tax was levied directly upon the incomes of ordinary industrial and mercantile corporations; but railroad, insurance, banking, and similar corporations were subject to an income tax equal to the lowest rate imposed upon individuals—first 3 per cent, then 5 per cent, and later 2½ per cent. In the Revenue Acts of 1913 and 1916, the rates of 1 and 2 per cent, respectively, imposed upon corporation incomes were identical with the normal tax rates on individual incomes, from which, moreover, dividends received from corporations were deductible for normal tax purposes.

So long as the range of normal and surtax rates on individual incomes was narrow—in the Revenue Act of 1913 the maximum surtax rate was 6 per cent—and so long as the rate on corporation incomes approximated the normal rate on individual incomes, from which dividends were exempt, it could be said that the law treated incomes derived through corporations on roughly the same basis as incomes derived from unincorporated business and from personal services. In other words, corporation stockholders were neither favored nor penalized to any substantial degree by our income tax laws.

Beginning with the Revenue Act of 1917, however, the surtax rates applicable to individual incomes were increased very drastically, the maximum surtax rate rising from 13 per cent in 1916 to 63 per cent in 1917, and to 65 per cent in 1918. The corporation income tax rate, on the other hand, was raised only to 6 per cent in 1917, and to 12 per cent in 1918. Although very high excess profits and war profits taxes were also enacted in 1917, they were modified in 1918 to apply only to corporations, and were dropped after 1921. In consequence of the sharp increase in the range and absolute rates of individual surtaxes, without any corresponding increase in corporation income tax rates, a very important disparity arose between the tax treatment

of corporation stockholders and the tax treatment of individuals deriving their incomes from partnerships, individually owned enterprises, and personal services. This disparity resulted from the fact that the earnings applicable to the shareholders' interests in a corporation but not currently distributed in dividends escaped the current individual income surtaxes; whereas the earnings applicable to members of partnerships, whether distributed or not and the earnings of individual business and professional men, whether reinvested or not, were subject in full to the schedule of individual income surtaxes.

Remedies Proposed

The privilege offered to corporation stockholders of allowing their share of corporation earnings to be directly reinvested for them without the current payment of individual income surtaxes thereon aroused considerable debate from the beginning. As early as December 27, 1917, the late Professor Thomas S. Adams of Yale University, who served as a consultant for the Treasury and the Congressional committees during the formative period of the Federal income tax, in discussing the Revenue Act of 1917, declared:

> "This question of taxing undistributed earnings carries us to the very heart of the difficult subject of business taxation. . . .
>
> ". . . Should not the sole trader and partnership enjoy the same privilege as the corporation? Unfortunately, we cannot answer this question lightly in the affirmative. To say to every business man that the income tax is to apply only to amounts withdrawn from his business would seriously impair the productivity of the income tax. Moreover, if the corporation, partnership, and the

> active business man are to be taxed only on the sums withdrawn for consumption, we should be logically compelled to exempt all salaries and other personal income which is reinvested or saved. And we could not stop here. Much of our consumption is productive. We could not consistently exempt profits reinvested in the saloon business and tax the average citizen upon the savings which he invests in the education of his children.
>
> ". . . In short, the undivided profits of a corporation should be taxed at the rates which would apply if such profits were distributed to the shareholders. . . ."

When the Senate Finance Committee first reported the bill that became the Revenue Act of 1917, a provision was included imposing a 15 per cent tax, in addition to the regular corporate income tax, on undivided earnings exceeding 20 per cent of the total net income. As finally enacted, the 20 per cent exemption was eliminated and the rate of additional tax was reduced to 10 per cent, applicable to that portion of the total net income, after Federal income taxes, remaining undistributed six months after the end of the calendar or fiscal year; but a broad new exemption was inserted that made the entire provision virtually ineffective. This exemption read in part, as follows:

> "The tax imposed by this subdivision shall not apply to that portion of such undistributed net income which is actually invested and employed in the business, or is retained for employment in the reasonable requirements of the business, or is invested in obligations of the United States issued after September 1, 1917."

The broad character of the permission to retain earnings, without tax liability, if such earnings are employed "in the

reasonable requirements of the business" made it extremely difficult to prove tax liability; and the entire provision was repealed by the Revenue Act of 1918.

It is interesting to recall that in the Civil War income tax laws, Congress solved this problem, with respect to ordinary industrial and mercantile corporations (though not with respect to railroad, banking, and similar corporations which were then relatively more important), by providing that individuals were subject to income taxes on their share of the profits and gains in the corporations in which they held interests, whether these profits were divided or not. In other words, all the earnings of industrial and mercantile corporations, whether distributed or not, were subjected to the individual income tax rates applicable to their shareholders.

Such a provision today would probably prove more difficult of effective administration, barring questions of constitutionality. The difficulties would arise from the enormous complexity of present-day corporate structures and from the daily changes in stock ownership that now take place. It is significant, however, that the problem met in this way by the Civil War revenue acts, so far as industrial and mercantile corporations are concerned, is, in substance, the same problem that confronted the Congress in 1916, and the very same problem that Congress again attacked through the Revenue Act of 1936.

I have noted that in 1918, the excess profits and war profits taxes that had previously been applicable to individuals, as well as to corporations, were restricted to corporations. The practical effect of limiting the excess profits and war profits taxes to corporations was to compensate in varying degree, and in some cases probably to overcompensate, for the preferential treatment accorded to corporation stockholders under the regular income tax provisions. By 1920, however, a very considerable demand

had arisen among business men for the elimination of excess profits taxes. In connection with many of the arguments advanced in behalf of such repeal, however, it was recognized that the mere elimination of the excess profits taxes, without any substitute provisions, would result in a pronounced tax advantage to corporation stockholders as against individuals deriving incomes from other sources. The most prominent of the measures then proposed to equalize the burden of taxation was a tax on the undistributed earnings of corporations.

For example, E. H. Jaynes of Cleveland, Ohio, representing the National Association of Credit Men, in testifying before the Senate Finance Committee on the proposed Revenue Act of 1921, declared in part as follows:

> "... we believe that the undistributed earnings of a corporation should be taxed in much the same manner and at rates comparable to the individual rates, and that later these earnings should be distributed tax free."

Likewise, Professor T. S. Adams, in an address before the American Economic Association in December, 1919, declared in part as follows:

> "But it will not suffice merely to abolish the excess profits tax. Corporations, in order to be placed upon something like an equality with individuals and partnerships, must bear an additional tax roughly equivalent to the surtaxes on undistributed profits paid by sole proprietors, the members of partnerships, and the stockholders of personal service corporations. This additional tax should apply only to undistributed profits."

As finally passed, however, the Revenue Act of 1921 merely re-enacted the excess profits tax for the year 1921, after

which it was dropped. In consequence, the disparity in the tax treatment of incomes derived from incorporated business and from other sources, which had been reduced, in practice, by the excess profits tax, was increased. Action to reduce or eliminate this disparity was again proposed in 1924, when the Senate passed the Jones Bill providing for a schedule of taxes on undistributed corporate earnings in addition to the ordinary corporation income taxes. This measure, however, was not approved by the House of Representatives.

Discussion of the problem persisted nevertheless. In 1923, Professor Adams, in an address before the National Tax Association, modified the position that he had previously taken and declared that "it would be inadvisable to put a premium on the complete distribution of corporate profits. We want corporations to save, to reinvest, to plow back their profits into the business. We admit that it would be undesirable to apply the high surtaxes to the savings made by corporations. . . ." On the other hand, four years later, a committee of the National Tax Association, reporting on Simplification of the Income Tax, declared in part as follows:

> "One method might be to place a reasonable tax on the corporation on that portion of the income which it does not actually distribute. It is impossible to make this amount even roughly approximate the revenue which would be collected, if complete distribution were made, as the conditions vary in each and every corporation. It should therefore rather be considered as a premium tax paid by the corporation for its stockholders, in exchange for retaining the earnings in the business and thereby postponing the normal and surtax until a future day. For that purpose a tax of 10 per

> cent on that amount of its net income which exceeds the dividends paid out in any year would be a reasonable tax.
>
> "Argument has been made that this form of tax is uneconomic, because it creates an incentive to pay out dividends instead of plowing the profits back into the business. One answer might be the question, Why should the Government permit corporations to accumulate partly tax-paid surplus to plow back into the business, where it insists on the full tax on surpluses of partnerships and individuals, even though they are plowed back into the business? The argument of an individual that he should receive an exemption from tax on that part of his year's earnings which goes back into his business would receive short shrift."

You will recall that under the Revenue Acts of 1921, 1924, 1926, and 1928, applicable to the ten years ended in 1931, the surtax rates on individual incomes were progressively and sharply reduced; so that from 1925 to 1931, inclusive, the maximum surtax rate was 20 per cent; and the corporation income tax rate during this period ranged from 11 to 13½ per cent. These reductions in the individual surtax rates, coupled with the maintenance of corporation income tax rates higher than the normal rates on individuals, moderated in part the preferential tax treatment of stockholders whose earnings were directly reinvested by their corporations, as compared with the reinvested earnings of individual business men and partnerships. But with the enactment of the Revenue Acts of 1932, 1934, and 1935, whereby individual income surtaxes were again increased substantially, this disparity once more became a serious problem.

During the discussions preceding the enactment of the Revenue Act of 1936, there were some persons who argued

that we already had adequate provisions on the statute books to deal with the use of corporations as a means of tax evasion, and that the comprehensive scope of the Revenue Act of 1936 was, therefore, unnecessary. In this connection, I should like to emphasize the fact that the problem of tax evasion is much narrower, and is in many respects distinct from the larger problem attacked by the Revenue Act of 1936. In other words, there is an important distinction between *tax evasion*, which implies deliberate intention to evade taxes, and *tax avoidance*, which is the use of lawful means of minimizing taxes.

From the very first revenue act passed under the Sixteenth Amendment, Congress has consistently adopted provisions aimed at the elimination of deliberate evasion of income taxes through the use of the corporate form of business organization. In the Revenue Act of 1913, and in all subsequent revisions of our income tax laws, provisions were incorporated to penalize what is termed "unreasonable accumulation of surplus" by corporations; and as recently as in the Revenue Act of 1934, Congress imposed special graduated surtaxes of 30 and 40 per cent on the undistributed profits of all personal holding companies, as defined in that Act, without reference to a standard of reasonableness. The range of graduation of these special surtaxes was made 20 to 60 per cent in the Revenue Act of 1935, and 8 to 48 per cent in the Revenue Act of 1936.

Revenue Act of 1936

The main problem attacked by the Revenue Act of 1936 was a different and broader problem, however. This broader problem was that of reducing a great disparity in the burden of taxation that resulted, not from attempts at deliberate evasion, but from the very character of our income tax structure. A measure of the amount of lawful tax avoidance made possible by the previous treatment of corporation

incomes is afforded by the revenue estimates submitted by the Treasury Department to the Congressional committees last spring. The Treasury estimated, for example, that, if there were no change in law, corporations could be expected to withhold from their stockholders more than $3.6 billions of their 1936 calendar year incomes; thereby sheltering a large proportion of their stockholders from the application of the individual income surtaxes to their share of such earnings. The Treasury further estimated that the Federal revenues from 1936 calendar year incomes would be more than $600 millions greater if, in lieu of the corporation income, capital stock, and excess profits taxes, corporation incomes were subject only to the equivalent of the individual income taxes of their stockholders.

The schedule of corporation income tax rates, normal and surtax, adopted by Congress in the Revenue Act of 1936, was designed substantially to equalize, on the average, the income tax burdens borne on the one hand by owners of incorporated business enterprises and on the other by individuals deriving income from other sources, and thereby to increase the Federal revenues by a major part of the previous amount of tax avoidance.

I hope that this brief review of the background of the Revenue Act of 1936 serves to illuminate the major considerations, upon which the Act was based. These considerations, as we have seen, have been prominent in the minds of legislators, informed business men, and other students of taxation for many years. The Revenue Act of 1936, however, represents the first attempt to deal comprehensively with this problem since the passage of the Sixteenth Amendment.

CHAPTER X

THE TAXATION OF UNDISTRIBUTED PROFITS FROM THE THEORETICAL POINT OF VIEW

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MY assignment reads "The Undistributed Profits Tax from the Theoretical Point of View" and I interpret that as calling for some general statements applicable to the tax without much emphasis on a particular revenue system or a particular time. The tax will first be discussed in its relation to what may be called the two primary aims of taxation—revenue and social control—and then some remarks will be made about its relation to tax justice.

REVENUE

The tax may be enacted for the same reason that most taxes are enacted—to increase the amount of tax revenue coming to the government within a given period of time. It can be a measure of great importance, so far as this aim is concerned. It increases the government's revenues in two ways. First, it increases the receipts from the personal income tax, since it exerts a pressure on corporations to pay more taxable dividends than otherwise.

Second, it may itself yield revenue in so far as corporations choose to pay it rather than avoid it by paying out earnings to stockholders. This second method will be of no importance if the rates of the tax are high enough to

force all earnings of all corporations out at once, leaving no undistributed profits at all to tax. There will always be some corporations, however, that will be under extreme pressure to retain at least some of their earnings, even in the face of a heavy penalty tax.

A special feature attaches to the increased revenue that is obtained by the first method—that is, paying out additional dividends so that the personal income tax yields more. This revenue is largely advance revenue. It is obtained during the given time period largely at the expense of some future time period. This is true for at least two reasons.

First, some of the additional dividends that are declared would instead have been declared in a future period. In other words, some of the dividends are simply paid sooner—many years sooner, perhaps—than they would be if there were no such tax. To this extent, the personal income tax shows an increased yield in the present period and a decreased yield in a later period.

Second, the additional dividends decrease the book value of each share of common stock and hence tend to decrease its market value compared to what it would be if there were no such tax. The result is a smaller capital gain—or a larger capital loss—in the future years when stockholders realize on their holdings by sale. The earnings of the corporation appear in the personal returns of the stockholders as dividends in the present period instead of as capital gains in a future period. Several exceptions to this generalization can be cited, depending largely on the particular kind of capital gains provisions that are in force. In general, however, this effect of the tax is likely to be an important one in increasing present revenue at the expense of future revenue.

It is unlikely that in any particular revenue system all of the increased personal income tax will be nothing but ad-

vance revenue. As already indicated, the treatment of capital gains and losses may be such as to make much of this new revenue truly additional revenue. The provisions governing carry-over of business losses from one year to the next are also important in this connection. Moreover, there is a saving of interest to the government in so far as it gets its tax revenue now rather than later.

The other source of revenue—the undistributed profits tax itself—is in very large part genuinely additional revenue. Of course, the profits available for dividends or for capital gain are smaller than they otherwise would be, by the amount taken out to pay the undistributed profits tax. The government loses the tax on the tax, so to speak. If a corporation has a profit of $100.00 and would pay it all out in dividends some day, an undistributed profits tax of, say, $70.00 leaves only $30.00 that can ever be taxed as a dividend. If the personal income tax rate applicable is, for example, 10 per cent, the government gets a total of $73.00 if it levies the undistributed profits tax, and $10.00 if it does not, and the additional revenue is therefore $63.00, not $70.00. This is a relatively minor factor, however, unless the personal rate is about as high as the rate of the undistributed profits tax.

In general, then, the revenue results of an undistributed profits tax are likely to be a mixture of a permanent increase in tax yield and a shifting of tax yield from a future period to the present period.

Social Control[1]

As a measure of social control the taxation of undistributed profits has many possibilities—and many limitations. Within the scope of this paper it will be possible to note

[1] For much of the material in this and the following section of the paper, acknowledgement is made of the development of the subject by Professor Roy Blough in one of the chapters of the forthcoming tax study by the Twentieth Century Fund, entitled *Facing the Tax Problem.*

only the more immediate effects of the tax. A study of the remote and more important effects of these effects is the task of the specialist in such fields as corporation finance and money and banking.

If the tax is to be an effective measure of social control it must force people to act in some way different from what they would without the tax. Moreover, the action must be designed to achieve some aim not connected with taxation. For example, the tax may force the declaration of a greater amount in dividends than otherwise, but if the amount is at once put back into the corporation with no different net effect than if it had never been paid out, no aim of social control can be achieved. This is true even if a result of the process is to affect the yield of the personal income tax and thus readjust the distribution of the existing tax burden or change the degree of tax consciousness, or in still some other way affect the tax system as such. Such effects are not here included in the term social control.

Whatever measure of social control the tax can effectuate must come of course chiefly as a result of the pressure it puts on boards of directors to declare more dividends, within the period considered, than they would otherwise. What are the immediate ends—outside of those relating solely to bettering the tax system, which, as already stated, are not included here under "social control"—that can be served by this pressure?

Here it becomes important to distinguish among several types of corporation.

As concerns the personal holding company type of corporation, the pressure exerted by the tax can serve practically no aim of social control. The money—less, of course, the personal income tax paid on the dividends—can be put back in the corporation at once without much net change in social conditions from what would obtain if there were no such tax.

Of course the fact that the owners have less money to leave in the enterprise, owing to the personal tax, is important. However, since the government in this way increases taxes on them (within the period considered), it may lighten other taxes on them. If, instead, it lightens taxes on others, the net social result of the program may be considerable, but it depends on much more than simply an undistributed profits tax.

The same remarks apply to all closely held corporations, including those carrying on an active business enterprise.

At the other extreme, however, with the large corporation that has a widely distributed ownership, several immediate ends of considerable importance can be served. This paper cannot consider whether the ends are desirable. Such a discussion goes far outside the field of taxation, and is too complex to be attempted even in part here. In any case, it is first essential to list some of the proximate results that the tax is likely to achieve.

By causing a larger part of the earnings to be distributed to stockholders at once, the tax requires the board of directors to leave to others the decision concerning what is to be done with the money.

These "others" include many people and organizations, but the chief ones to note are (*a*) the stockholders of the concern in question, (*b*) commercial banks, savings banks, and investment banks and (*c*) government regulatory bodies such as the Securities and Exchange Commission.

The first choice is made by the stockholder, who must decide whether to spend or save the additional dividends. If he decides to save there will be, according to certain analyses of the money and banking system, a further choice between investing and not investing. The stockholder may turn the matter over to a savings bank by depositing his money there. Finally, a decision is needed whether to reinvest the money in the same company, or, if not the

same company, in the same industry. Here the influence of the governmental regulatory bodies is likely to be felt.

If as a result of this chain of decisions, the money does not get back to the particular company whence it came, the commercial banks may be requested to pass on the advisability of the directors' projects, or the investment banks and underwriters may instead be the ones to have the veto power.

By merely scattering the power of decision among a large number of persons and organizations, the government does not achieve a very precise measure of social control, but it opens the way for a wider and more flexible use of complementary control measures—exemplified by the powers of the Securities and Exchange Commission—that are entirely outside the field of taxation.

Up to this point the discussion of social control has assumed that the dividends are paid out of the assets of the corporation. It is possible that the dividends will be paid only in the form of hitherto unissued stock of the corporation. Such a distribution does not take any assets out of the corporation, does not pass to stockholders and others the decisions just noted about saving and investment, and therefore does not open the way for social control.[2]

Omitting important qualifications, it may be said that the kinds of dividend in stock that are relevant at this point are dividends in the form of common or preferred stock to holders of preferred stock, and dividends in the form of preferred stock, provided some preferred stock is already outstanding, to holders of common stock. In so far as earnings are paid out in these forms, rather than from the assets of the corporation, about the only measure of social control that can be achieved is the increased use of preferred stock.

[2] Somewhat the same result may occur through the payment of cash dividends coupled with a right to buy stock at well below the market price. Stock rights of this kind exert a strong pressure on the stockholder—or the person to whom he sells the right—to put the money back in the corporation.

The increased use of preferred stock may come about in another way, regardless of the form in which dividends might be distributed. The pressure exerted by the undistributed profits tax is likely to lead to an increase in the use of preferred stock in place of bonds. If a corporation earns $1,000,000 before payment to any investor, of which $400,000 belongs to the common stockholders, and if they wish to retain this $400,000 in the business, consider the difference in the situation if they are paying the other $600,000 (*a*) to holders of preferred stock, or (*b*) instead, to holders of bonds. In the first instance their profits are $1,000,000 of which $400,000 is kept undistributed—that is, only 4/10. In the second instance, their profits are $400,000—since bond interest is deducted in computing profits—of which $400,000 or 100 per cent is undistributed. Presumably, the size of the undistributed profits tax will depend not only on the absolute number of dollars of profit withheld, but also on the ratio between the undistributed profits and total profits. If bonds are used instead of preferred stock, the ratio is high and the tax is correspondingly large.

Tax Justice

If corporations do not distribute all their current earnings at once as dividends, it is very difficult for the government to tax a stockholder immediately, under the personal income tax, on his full share in the earnings. All that it can do, usually, is tax him on that part of the earnings that is distributed in dividends. The reasons for this difficulty cannot be explained here, but, in general, they concern such problems as yearly inventorying of all property and complexities in the distribution of a corporation's income caused by non-cumulative preferred stock.

It may be asked why it is important to tax the stockholder at once on his full share of the earnings, especially since the

corporation can be taxed directly, and, moreover, the stockholder is likely to be taxed some day, through higher dividends or capital gains in later years.

One reason often given is that an investor in an unincorporated enterprise—a sole proprietorship or a partnership—is readily taxable at once on his full share of the concern's earnings, and equality of treatment demands that the same procedure be followed for corporation owners. This reason, however, simply refers the discussion back to a more fundamental point: why should any investors—stockholders, partners, or sole proprietors—be required to pay a personal income tax on shares of current business earnings that are kept in the business?

In the first place, the owner does experience an increase in his economic power to support the government, and the increase occurs when the earnings are made, since it can be realized in cash by a sale of part of the investor's stockholding in a corporation, or by withdrawal of funds from a proprietorship or partnership, or by borrowing on the increase in the assets of the company.

Possible exceptions to this statement occur when a stockholder has but one or a few shares of a corporation, for whose stock there is practically no market at all, or when the earnings of an unincorporated business are obtained by an increase in an asset that can by no means whatever be turned into the cash that the government demands. If contributions to the support of the state are to be linked chronologically with the increases in economic power, practically all current earnings must be taxed.

Probably the chief reasons for demanding this chronological linking are (*a*) the change in the effect of the surtax rate scale—a change that may be made consciously by the taxpayer, as when he times the distribution of earnings so that his total increase over the years is made more even and he thus escapes the higher bracket rates, or that may be a

fortuitous sort of change, not particularly planned by anyone; (*b*) the saving in interest that the investor makes at the expense of the government if he is allowed to postpone the tax liability.

Even if the chronological linking is not considered important, a reason remains. If the earnings are not taxed to the stockholder in the year in which they arise, loopholes of the kind that exist in any tax law may allow the stockholder to avoid permanently, rather than merely postpone, the tax. As an illustration there may be cited the failure of the income tax laws in the United States to tax, under the capital gains provision, the increase in value of the taxpayer's capital asset that occurs from the time he buys it to the time he dies.

In so far as an undistributed profits tax forces out in dividends the full earnings of the current year, they can of course be taxed at once under the personal income tax. For this objective, it is not necessary—as it is for most of the social control points at issue—to force the corporation to distribute assets. A taxable stock dividend does just as well.

This discussion of tax justice assumes that the undistributed profits tax forces earnings out as dividends. In so far as the tax fails to do this, it raises another set of issues that are better handled under a discussion of income taxes in general on corporations—and a large part of that topic is outside the scope of this paper.

Summary

As a summary of this approach to some of the more important theoretical aspects of undistributed profits taxation, it may be said that the tax has important revenue aspects, particularly because of its ability to increase present revenues at the expense of the future; that as a

measure of social control it is not a very refined instrument in itself, but can open the way for control measures of a non-tax type; and that it is one of the ways in which the economic power that is represented by corporation earnings can be taxed under the personal income tax as soon as it arises.

CHAPTER XI

FINANCING SOCIAL SECURITY BY MEANS OF PAYROLL TAXES

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THE Federal Social Security Act is a landmark in social legislation in the United States. It points the way to a new era in economic security. To wage earners, it holds out the hope of greater security in old age and for limited periods of unemployment. To business men it means stabilization of purchasing power during periods of depression; it also means new taxes whose first impact is largely on the employer.

From a fiscal viewpoint, the security act means the expansion of government functions due to a changing political philosophy. New services mean added expenses and new bureaus. Financing these enlarged social services requires new taxes which it is estimated will cost within a decade approximately four billion dollars annually. The improved services should promote national welfare; but the accompanying taxes may have far-reaching and unforeseen economic effects upon the organization of business and business profits or upon wage rates or prices.

The humanitarian purposes of the legislation are universally applauded. The inadequacies and imperfections of the initial act are generally acknowledged. The financial aspects of the problem, however, are much less commonly understood. They are often neglected, and their varied

effects are rarely appreciated even by close students of the problem.

Payroll taxes are the very life-blood of the social security program. In financing social security they are comparable in importance with property taxes in the support of state and local functions, with gasoline taxes in the construction and maintenance of highways, and with income taxes and excises in the maintenance of federal services. They are the main financial support of the old age and unemployment provisions of the act. The term "payroll" is used here in a broad sense, including both the excise tax imposed on employers and the income tax levied upon the wages of workers.

What part of the social security program will be financed by payroll taxes? Are they an adequate and reliable support for the Federal-state social security structure? Are they the most suitable, or available foundations for social security? How much reliance will be placed upon them compared with taxes with which we are now familiar? Will they be borne by the persons who pay them in the first instance, or will they be shifted? Who will ultimately foot the bills? Will it be the employer who will have to be satisfied with lower profits, the laborer who will have to accept lower wages, or the consumers (including laborers) who will have to pay higher prices? How will the payroll taxes affect the character of Federal and state tax systems and the distribution of Federal and state tax burdens? These are some of the questions that ought to be considered.

It should be pointed out that only a part—perhaps not over half—of the sum total of funds required to support the needy aged, the unemployed, and to provide certain other types of social security will be raised by payroll taxes. Other taxes—primarily the old reliable property tax and income and sales taxes—must provide the support of all the needy aged, of all the aged and unemployed in excluded

occupations, and of those unemployed who are covered by the act after they have exhausted their benefit payments.

A comprehensive treatment of the fiscal aspects of payroll taxes and a fair valuation of their probable effects demands the consideration of these complex and baffling questions. Neither the limits of this paper nor the time and resources of the writer permit the thorough examination and research which the subject merits. It is the purpose of this paper primarily to raise major issues, to suggest some of the possible variations in the incidence and effects of payroll taxes, and to attempt a tentative evaluation of these taxes when related to the benefits proposed, the complementary taxes involved, and the canons of a good tax system.

Taxes Involved in Financing Social Security

A brief review of some of the major provisions of the act is essential to an understanding of their effects and to a fair evaluation.

Funds to finance the social security program are to be raised from three groups of taxes. In the first group are payroll taxes which are both new and substantial. They are the main sources of revenue for financing old age annuities and unemployment compensation. There is also a tax on the wages of workers intended to yield half of the funds for old age annuities which may best be considered along with the employers' payroll taxes. The rest of the program is to be financed by the United States government and by the several states out of general revenues. This means that a second source of revenue will be Federal taxes on incomes of individuals and of business, excise taxes on liquors, tobaccos and other articles, the Federal estate tax, and customs duties. The third source will be state tax revenues, primarily the property tax—that dependable old engine of state and municipal finance which is now creaking under

its heavy load. This will be supplemented by objectionable sales taxes in many states, by inheritance and gasoline taxes generally, and in a few states by fairly substantial income taxes. These taxes collectively will furnish funds for meeting several different kinds of insecurity.

Two distinctly different methods of support in old age are provided for, and they need to be carefully distinguished. The first type is a distinctly Federal program. This plan provides for the payment of annuities to persons over 65 years who have contributed to their cost. It is a sort of nation-wide public old age insurance or benefit scheme which pays a monthly income for life (after 1942) to retired employees over 65. Unlike a true annuity, this plan compels contributors to retire from work before they are entitled to any benefit at all. It does not cover all persons over 65 because it exempts workers in agriculture, in domestic service, in government work—Federal or state—all casual workers not related to the business, those working for charitable, educational, and similar non-profit making institutions, those working for themselves, and a few others. Only about half of the workers are included. Those covered by the act are compelled to pay taxes to the Federal Government after January 1, 1937. These contributions will be deducted from the pay envelope of the employee beginning with 1 per cent of wages or salary in 1937. The rate rises by ½ per cent every third year until it reaches a maximum of 3 per cent in 1949. The employer contributes an equal share. After 1949 the combined contributions will equal 6 per cent of the payroll. Earnings in excess of $3,000 received by any one person from a single employer in one year are not taxed. Within ten years these taxes are expected to amount to about $1,500,000,000 annually.

From this fund, and later on partially from other taxes, annuities varying from $10 to $85 per month will be paid, the exact sum amounting to a decreasing per cent as wages

increase. If a worker dies, his estate will receive at least the balance of what he paid in. That much is guaranteed.

The second type of provision for old age is known as old age assistance. It is intended for aged persons who are excluded from the annuity plan. It is a system of Federal grants-in-aid to states which adopt approved plans of their own. This is a form of poor relief intended for needy aged persons who are in occupational groups *not* covered by the contributory plan, or who are so near to 65 that they cannot build up the needed reserves. The Federal grants will amount to 50 per cent of the total payments of the states up to a maximum of $30 per month; in addition, a grant is made to cover administration expenses. The purpose is to stimulate states to give larger pensions to the needy aged. Certain conditions must be met to secure the grant. Funds will be derived from any tax revenues the Federal and state governments may choose to use, but no payroll taxes are imposed to support this part of the program. Actuaries estimate that old age assistance will cost something like $1,000,000,000 annually within a decade, though their estimates vary.

The plan of compensation for unemployment is different from either of these. The Federal Government is not setting up an unemployment insurance plan of its own. It is nevertheless imposing a tax on employers which amounts to 1 per cent of their payrolls in 1936, 2 per cent in 1937 and 3 per cent thereafter. In states which adopt unemployment insurance plans acceptable to the Social Security Board, employers may deduct or be credited with 90 per cent of the tax paid to the Federal Government. The purpose of the crediting device—which is patterned after the 80 per cent credit in the Federal estate tax—is obviously twofold. First it aims to persuade, coerce or make it profitable for the states to adopt unemployment compensation plans of their own and thereby to retain payroll taxes for use within the state.

Secondly, it aims to prevent unfair competition between the states and thus to permit the adoption of unemployment compensation by the states. The scope of the law is somewhat narrower than the old age annuities plan. It excludes not only workers in agriculture, in domestic service, in government or public service and in the employ of non-profit making institutions, but it also excludes persons employed by relatives and those who work in establishments employing less than eight persons.

For the purpose of this study, the essential features of the security act as affecting unemployment compensation are (1) that a uniform payroll tax is levied upon employers of eight or more persons throughout the country; (2) the tax, though widespread in its application to industrial and commercial establishments (except for size), is not universal or general as applied to the gainfully employed because about half of them are excluded from the scope of the act; (3) unfair competition or advantage to employers in any given state is eliminated by use of the crediting device which has been employed for about a decade in Federal estate taxes.

The ultimate effect will be to impose upon payrolls of employers who are included within the scope of the act a tax of 3 per cent of the payrolls. This applies to employers in states which have no unemployment compensation plan as well as to states which do. It applies regardless of provisions of the state law relating to residence, waiting period, benefits, etc. The crediting device is coercive in the same sense as the corresponding provision in the estate tax. A decade ago that provision of the estate tax was generally criticized as limiting the sovereignty of the states. Today it is generally accepted as beneficial to the states as well as to the Federal Government; and it has been held to be constitutional.

Incidence of Taxes on Wages and Payrolls

Conflicting Views

Can taxes on wages and on payrolls be shifted when levied in these amounts and under the conditions specified? The popular assumption is that business men will be able to shift taxes on their payrolls; but it is not clear how this can be accomplished or to whom the burden will be shifted. The confusion relating to the incidence of the payroll taxes may be indicated by a few typical reactions.

One well known manufacturer says that most business men expect the increased cost will be recovered in higher prices, that is, that payroll taxes will be shifted forward to consumers. There is no expectation on the part of business, he says, that they will appear as reduced wages. This view probably represents the most common popular belief.

A banker argues that whatever the employer pays in payroll taxes will sooner or later be taken out of labor in reduced wages (or in a slower rate of increase in wages); or if reductions in wages are resisted, in an increase in unemployment. The immediate effect, he says, will be a lowering of the profits of business. Ultimately the taxes will be shifted back on labor in the form of lower wages.

A third business man in a booming industry regards a four or five per cent payroll tax as relatively insignificant, that is, relatively too small in amount to have any appreciable effect either upon prices or wages. He does not expect it to be shifted either forward or backward.

One student of the problem who enjoys wide contacts both with labor and with employers says the average man believes that all of the payroll taxes, both those paid by employers and those taken directly out of the pay envelope, will be borne by labor in one way or another: either in the form of lowered wages or of higher prices for goods.

Finally, all of these views may be found in a single dis-

cussion of the social security problem. The assertion may be made in one place that every tax on business is shifted forward to the consumer; in another place the assumption is made that social insurance is borne entirely by labor; and elsewhere that it comes out of the profits of the business man.

In spite of the confusion of thought illustrated by these conflicting views, it is probable that nearly everyone of them contains an element of truth. American industry represents such a wide variety of conditions that no general conclusion is possible. In some industries, wages may constitute a major element in costs; in others they may play a minor part. In one instance the payroll tax is a heavy burden, in another a light one. In the first instance it could not long be borne by business; high cost producers would fail. In the other, it might well be borne or absorbed by the industry. A manufacturing industry may be undergoing rapid technical developments; unit costs are falling; wage rates are increasing; payrolls are not a major item in costs; prices are firm or rising; nevertheless expanding production cannot keep pace with increasing demand. The tax is hidden in these dynamic changes and may even stimulate further improvements which will reduce costs. It appears to burden no one.

Conditions Favorable to Shifting

Under what conditions therefore may a tax be shifted? Primarily, it will take place through a change in price; occasionally through a change in quality or in the size of the package. This will tend to occur when the tax is of sufficient amount to give a motive for shifting; in cases where some sale or exchange takes place, and where the tax is general affecting all objects in the same competing class. If the tax is unequal within a group of competing objects, it will be difficult if not impossible to shift all of it forward. It is easier to shift to consumers when the demand for the

product is relatively inelastic. Furthermore, the tax is rarely shifted unless it sets in motion forces which restrict supply. This is usually brought about under competition by driving out high-cost or marginal producers.

Taxes Levied Directly on Wages of Labor

Are payroll taxes sufficient in amount or of such a character that they will probably be shifted? If so, how and to whom? Consider first the tax which is deducted from the pay envelope of the workers under the contributory old age annuity provisions.

A tax in proportion to the wages of labor is equivalent to an income tax on the wages and salaries received in the employments covered. When viewed as an adjunct to the Federal income tax, it is difficult to see how it can be shifted. The security act covers, however, only about half of the gainfully employed. A very heavy tax on wage earners in the taxed field might conceivably lead enough of them to transfer from the taxed industries to the untaxed ones to affect the supply of labor and therefore to raise wages.

This result seems very unlikely in the present case for two reasons: (1) Little direct competition appears to exist between workers employed in manufacturing and merchandising industries and those in the exempted occupations: agriculture, domestic service and public employment. If the tax on wages should induce an appreciable number of girls, for example, to shift from clerical work for business men to clerical work in the employ of governments or of non-profit institutions, a tendency might exist for the tax to be shifted. (2) A second reason why this seems improbable is because all payments in the form of taxes on wages for old age annuities are returned to labor itself. They are not taxes for vague, unknown public purposes. In reality they are compulsory savings for old age and are equivalent to postponed spending. They may even make the taxed occu-

pations more attractive rather than less desirable because of the anticipated payment of benefits from the combined payroll taxes.

If the tax on wages is ever shifted it would be under most unusual circumstances. It is conceivable, perhaps, in trades where the following improbable combination of conditions prevails: where labor is strongly organized; where the tax—disregarding future benefits—is treated as a reduction of the customary standard of living; where it is used effectively in bargaining with employers under threat of a successful and costly strike; where the rules and strength of the union enable it to restrict the supply of the particular type of labor, and where the added cost is small and the demand relatively inelastic.

The increased wage might conceivably be absorbed by the industry without burdening either the consumer in higher prices or the business man in reduced profits. This might happen if the rise in wages was instrumental in bringing about improved morale, increased efficiency and lower unit costs.

It is impossible to consider here all of the conceivable situations. But in general it appears that the tax which is deducted from the wage earners' pay envelope is a form of compulsory saving for his own old age. It is not a burden on him except temporarily. It neither reduces the supply of nor increases the demand for his services. It is unlikely to induce labor to shift to occupations outside the scope of the act. Therefore it is difficult to see how it can be shifted. It will generally be borne by the person whose wages are taxed: the person who will receive the subsequent old age benefits.

Employers' Payroll Taxes

What is the incidence of the employer's payroll tax? He must ultimately pay 3 per cent for old age benefits and

3 per cent more for unemployment compensation. Will these taxes be heavy enough to afford an inducement for shifting? If so, will they be shifted forward to consumers in higher prices or backward to labor in lower wages?

The problem is complex and needs careful research. The most probable result is that the degree to which the tax can be shifted will vary widely, depending upon the nature of the industry and the length of the period considered.

Census figures show that labor costs and payrolls vary widely both between industries and between establishments within an industry in relation to the value added by manufacturing or to the value of the product. In some industries the ratio of wages and salaries to value of output is 10 per cent or less. The manufacture of cigarettes, the liquor industry and petroleum refining are examples. At the other extreme payrolls may represent over 60 per cent of the value of the product, or 75 per cent of costs added by manufacturing. In many other major industries the percentage of labor cost to value of product ranges from 40 to 50 per cent, or nearly half. Included in this group is the manufacture of machine tools, agricultural implements, pottery, shipbuilding and railroads. In other industries: boots and shoes, cotton goods, silk and rayon, men's clothing and iron and steel, payrolls amount to only 20 to 30 per cent of value of output. Obviously payroll taxes will appear as light burdens in some cases and relatively heavy in others.

Professor Hansen, in an earlier preliminary study,[1] concluded that a 2 per cent tax on payrolls would be in general a relatively light burden. Using 1929 figures he estimated that a 2 per cent tax would be equivalent to about ¼ of 1 per cent per dollar of sales value, or about ¾ of 1 per cent per dollar added by manufacturing. In only ten out of

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[1] A. H. Hansen and M. G. Murray, *A New Plan for Unemployment Reserves.* See Chapter 4.

thirty industries studied did he find the added cost of a 2 per cent payroll tax equal to 1 per cent of the value added by manufacturing.

A six per cent tax on payrolls, 3 per cent for old age annuities plus 3 per cent for unemployment compensation, would obviously be much heavier. It might equal, for manufactured goods in general, 1 to 1¼ per cent of the value of the product. In some industries, for example coal, it might amount to 3 per cent of the selling value; in the competing oil industry it might be only half as much, and in electric power still less. In other industries it would be so small that it might be offset or absorbed by increased efficiency and technological developments. In the liquor industry and in flour milling it would probably amount to less than ⅓ per cent and would probably not be a significant factor influencing price. It would be a smaller item of costs than some employers who, without raising any question as to its effect upon the price of the articles or the competitive position of their business, have already assumed in their experiments with old age pensions. In some industries, therefore, payroll taxes will probably *not* be shifted at all but will be absorbed by a developing industry without affecting anyone adversely.

In other industries, where labor costs represent nearly 50 per cent of the selling price, payroll taxes will be relatively heavy. They will be equivalent to a substantial increase in labor costs. Since payroll taxes hit all industrial employers—both those making a profit and the high-cost marginal firms who can just stay in business—it would seem likely that they will be shifted. The increase in cost, if substantial, will sooner or later force marginal employers, if they are to remain in business, to economize in the taxed factor—payrolls—by reducing the number employed or the wage rates. This must follow if we assume that the workers at the time the tax is levied have been receiving a wage equal to the

value of their marginal product; if furthermore we assume that the tax gives rise to no increase in the efficiency of labor, or in the demand for goods; and, finally, if we assume wage rates to be inflexible. To assume that payroll taxes will bring about a general rise in prices is equivalent to assuming that they will cause an increase in the supply of money, or of bank reserves, or in the velocity of circulation, or reduce the total volume of trade.

The *immediate* effect of the tax will be an attempt by business men to pass it on in the form of higher prices. Many people assume that this can readily be done. It is a naive assumption. Economists recognize that a rise in price by the amount of the tax is impossible unless the tax brings about either a real increase in demand, which is most unlikely, or a decrease in the supply of goods and services. In so far as laborers are dropped because they add less to the value of the product than they cost the employer, wages and tax combined, or in so far as marginal firms are forced into bankruptcy because they cannot sell their goods at the higher price, supply may be reduced and the price will therefore rise. A rise in price would curtail consumption and would tend ultimately to increase the number of laborers seeking jobs. It would therefore tend to be temporary; because in so far as wage rates are flexible, wages would fall and costs would be reduced. In industries where labor organizations are powerful enough to prevent a reduction in the rate of pay, some of them may be laid off and consequently the number of workers competing for jobs in other fields may increase and bring down wages in these other industries.

Our tentative conclusion is therefore that the incidence of the payroll tax will probably vary widely from industry to industry. The first effect will probably be to reduce profits. In industries where labor costs are high, where labor organizations resist cuts in wage rates and where

demand is highly inelastic, supply may be reduced and prices raised, but at the expense of a reduction in wage rates elsewhere. There is no reason to believe the tax would raise prices generally. It is also clear that unequal taxes in competing industries could not be passed on in higher prices. Moreover some prices are inflexible—five cents for gum or a cigar—and cannot readily be adjusted for a small tax, except perhaps by a change in quality. In some industries the tax will be very small. It has been estimated that a 6 per cent payroll tax would add only 1/10 of a cent to the price of a loaf of bread or ⅓ of a cent to the cost of a gallon of gasoline. On the other hand, the tax will sometimes be very heavy and cannot be borne by marginal firms. If wage rates are flexible, as is assumed under perfect competition, wages will ultimately fall because of increased numbers competing for employment. We must conclude that in industries where payroll taxes are heavy, they will tend to be shifted by employers in the long run largely to wage earners.

The assumed conditions necessary for shifting the tax back on labor are however so numerous and so frequently *not* present that many employers will find it impossible for long periods to transfer the burden. Wage rates are not perfectly flexible. Adjustments cannot be effected at once. Meanwhile the impact of the tax will be on business.

If, however, payroll taxes are first imposed in the rising phase of the business cycle, as at present, at a time when business is improving, profits and wages are rising and employment is increasing, both the immediate effect on profits and the more remote effects on wages may be obscured, though none the less real. The effect will be merely to retard the increase in business profits and in wages and the rate of re-employment. Neither laborers nor business will be fully conscious of the contributions they are making. Consumers may appear to be bearing the entire burden.

Payroll Taxes Justified as Valid Application of Benefit Principle

When unemployment insurance benefits run out, the state will step in and contribute some form of relief, whether through a dole or some form of work relief. In periods of prolonged unemployment, payroll taxes will cover only a small part of the costs of caring for the unemployed. The state will therefore be a major contributor out of general tax revenues. Even borrowing does not shift the burden from taxpayers. It merely postpones the date when the tax bills are sent out and increases their amount. Benefits for the aged will likewise be provided to only a limited extent from payroll taxes. The entire cost of old age assistance must be met out of general taxes, Federal and state. And after 1967 over $1,000,000,000 annually must be secured from Federal taxes to meet interest payments on the reserve fund debt, unless these provisions of the act are abolished or materially altered.

The use of payroll taxes is therefore a limited application of the benefit principle: based on the belief that certain costs may fairly be assessed in part upon direct beneficiaries of government activities. Far from being a discarded or obsolete principle, it is being increasingly recognized as sound and valid. It may advantageously be used to supplement the ability and fiscal theories over important areas of the field of state activity. It is being applied here not only in order to make the security program partially "self-sustaining." It is essential in order to make it possible at all on a broad scale under present conditions. The principle has a valid place in the social security program; but this argument does not justify the practice of levying heavy taxes upon wage earners in the next decade in order to relieve a future generation of part of the cost of its security.

The limited use of payroll taxes to finance a minimum of social security is comparable in every way to the use of gasoline taxes to provide a more adequate, up-to-date, coordinated system of hard-surfaced roads. If we had relied solely on state income taxes—that is, on the ability principle for highway construction and maintenance—we should now be driving automobiles over horse and buggy roads.

Payroll taxes are no more unjust or burdensome than are gasoline taxes. They are not used to build useless battleships or for boondoggling. They are more accurately described as compulsory savings than as taxes in the ordinary sense. Every cent paid out by labor in old age taxes will be returned in the form of an annuity to the laborer, or to his estate.

Unimportant modifications of this rule have been introduced for valid reasons. The younger workers will subsidize older ones to some extent; and higher salaried employees will likewise subsidize those receiving low wages. For a few years the Federal Government may derive some general funds from the 3 per cent tax for the unemployed which has been paid by employers in states which have not adopted an unemployment compensation system. In all cases ten per cent of this tax will be retained indefinitely and this may be more than sufficient to cover the costs of administration.

Supplementary Taxes: Their Importance and Possibilities

In addition to the payroll taxes, other taxes approximately equal in amount must be raised sooner or later in order to carry out the social security program as a whole. These funds must come from general tax revenues of state and national governments. They will be a partial though not a complete addition to current taxes for similar functions.

What are some of these other unnamed taxes upon which the security program partially rests? The main reliance of the Federal Government is and will continue to be income taxes and special excises on semi-luxuries, supplemented by estate taxes and customs duties. On the whole this system is probably moderately progressive; in the upper brackets it is highly but unevenly progressive. Contributions from the United States government will come from these taxes in unpredictable proportions in order to meet at least part of nearly every one of the services. Increasing emphasis is being placed on taxes on the wealthiest individuals and on the larger corporations. Further increases in revenue must apparently come largely either from persons of moderate means, in increased normal taxes, or from those now untaxed, by lowering the exemptions. Both of these changes are economically and fiscally desirable and are overdue; but they have appeared to be politically inexpedient if not impossible up to the present time. The payroll taxes will be complementary to the income tax in this respect. In combination, they should prove a more stable and reliable basis for the security program than exclusive reliance on either one alone.

Some social reformers will disagree with this conclusion. They naively assume that the costs of social security can actually be met merely by increasing income taxes in the upper brackets. And they regard this as desirable because of a blind faith in the ability theory. Since the Federal Government now takes an average of 65 to 70 per cent in the highest income tax brackets, and other taxes—state and Federal—must be added to this, it is a delusion to believe that a social security program comparable in scope with the present act can be financed largely by taxes on the wealthy. The funds would be utterly inadequate. It would be offering the needy aged and the unemployed a stone when they ask for bread. There is nothing in the

act, however, to prevent as heavy a reliance on income and inheritance taxes as is fiscally and politically feasible. Contributions from the aged might be reduced somewhat. But without payroll taxes, revenues would be too inadequate a foundation on which to build a four billion dollar superstructure of benefits.

If one compares payroll taxes for the support of old age with property taxes as administered by most states today, payroll taxes should receive a high rating. A 3 per cent payroll tax may be paid out of income, even if it is distressingly small. Property taxes have often been levied in recent years when there was no income whatever. That has been true in many farming communities for nearly a decade, and elsewhere. Moreover property tax rates are often as high a percentage of assessed value as the direct payroll tax on wages is of income. As a percentage of one's income, property taxes often absorb one-third or one-half of the income. To transfer an increasing share of the social security tax load upon the states would mean a more complete breakdown of property taxes which are staggering under their present load. It would mean greater reliance upon objectionable sales taxes, and a small amount from income taxes. However desirable income taxes may be, they cannot be expected to produce in the near future anything like the prodigious sums required for financing social security or even for meeting the costs of other state and local activities: the difficulties are constitutional, political, economic and administrative. The development of income taxes as a major source of revenue will come slowly in states with which I am most familiar.

Payroll taxes should therefore be retained to a large extent. They will prove immensely productive. They can be justified on valid grounds as one element in financing social security, even though they may generally be borne by wage earners. Supplementary revenues should be drawn

from income taxes so far as that is politically feasible and fiscally possible. A union of diverse tax sources will strengthen the entire social security program. With payroll taxes, a measurable degree of security seems possible. Without them it would appear to be impossible in our time.

CHAPTER XII

FINANCING SOCIAL SECURITY: RESERVES VERSUS CURRENT TAXATION

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In discussions of the Social Security Act there has been much controversy over financing on a reserve or a "pay-as-you-go" basis. To arrive at a dispassionate appraisal of the issues involved in this controversy it seems desirable to begin with the provisions of the Social Security Act.

Reserves are mentioned only in Title II of this act, which deals with old age benefits. All of the many aids which the Federal Government gives to the states for social security purposes are financed by an annual appropriation from general revenues. This includes the aid for old age assistance, which will probably cost the Federal Government $200,000,000 in the next fiscal year and rapidly increasing amounts thereafter.

There also are no provisions for reserves in the part of the act which deals with unemployment compensation. The Social Security Act does not establish a Federal system of unemployment compensation, but merely levies a tax on employers, against which they are allowed to offset their contributions to state unemployment compensation funds. Whatever revenue the Federal Government may derive from this tax is not earmarked in any manner, but will be expended currently for general Federal purposes.

Under the state unemployment compensation laws some reserves will be accumulated. These reserves, however,

are not likely to reach any staggering figures. Professor Hansen has estimated[1] that if there had been in operation throughout the United States from the beginning of 1922 unemployment insurance laws calling for contributions of 3 per cent on payrolls, a reserve of a total of four billion dollars would have been accumulated by the beginning of the depression in October, 1929, under a system of compensation paying less liberal benefits than those of any laws which have been passed to date in this country. All foreign unemployment insurance laws contemplate the creation of reserves in periods of prosperity from which benefits can be paid to unemployed workmen in periods of depression. In no country, however, has any large reserve ever been accumulated. The real problem in unemployment compensation has ever been, and is likely to continue to be, not one of reserves, but one of collecting enough money to pay promised benefits.

This leaves the so-called "Federal old age insurance system" as the only part of the social security program in which there is any reserve problem. Even in this part of the act there is mention of a reserve only in the section which provides for an "old age reserve account" in the Treasury of the United States, to which Congress is authorized to appropriate annually "an amount sufficient as an annual premium to provide for the payments required under this title, such amount to be determined on a reserve basis in accordance with accepted actuarial principles, and based upon such tables of mortality as the Secretary of the Treasury shall from time to time adopt, and upon an interest rate of 3 per cent per annum compounded annually." The old age benefits under Title II are to be paid from this account, and any amounts not needed immediately are to be invested in securities which bear 3 per cent interest and

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[1] In Hansen, Alvin H. and Others, *A Program for Unemployment Insurance and Relief in the United States*, (Minnesota University Press, 1934), pp. 166–196.

which are direct obligations of the United States Government or guaranteed as to principal and interest by the Government.

Based upon these provisions, critics have asserted that the Social Security Act provides for financing on a reserve basis and that the act contemplates a reserve of 47 billion dollars. Such a reserve exceeds by more than one-third the entire present debt of the United States. A reserve of this size, it is argued, will prove a constant invitation to unreasonable increases in benefits or to the diversion of the funds to other purposes; even if left intact, it will not reduce the cost of old age benefits in future years, since taxes must be raised to pay the interest on the securities owned by the old age reserve account. To avoid these difficulties, these critics urge, old age benefits should be financed on a "pay-as-you-go" basis—by which is meant the levy of taxes sufficient only to meet the current disbursements or which, at the most, will result only in a small reserve, sufficient to offset expected reductions in tax yields in depression years.

Financial Provisions of Social Security Act

Leaving for the moment these arguments and conclusions, it is desirable to examine a little more closely the financial provisions of the Social Security Act. First of all, it should be noted that the Act does not make any appropriations but merely authorizes Congress to make appropriations annually for specified purposes. The authorization for an annual appropriation for old age benefits is the one which has been quoted in full. This limits the annual appropriation for this purpose to an amount "sufficient as an annual premium" to pay the benefits under Title II, as "determined on a reserve basis." Congress is not required to appropriate such an amount, but may not exceed this figure. Limitations of the total amounts which may be appropriated occur in many other sections of the Social Security

Act, and Congress in making appropriations under these sections has in nearly every case appropriated less than the maximum authorized appropriations. This is a common practice in the Federal appropriation procedure, and there is every reason to expect that Congress will not always make the maximum authorized appropriation to the old age reserve account. As far as anything in the Social Security Act is concerned, Congress is free to finance old age benefits on any basis which it deems advisable. The maximum appropriation which it may make is an amount computed on a reserve basis, but, if it so desires, it may finance old age benefits on a "pay-as-you-go" basis.

The amount which was actually appropriated to the old age reserve account for the current fiscal year was the total of the revenues expected to be collected during this year from the taxes levied in Title VIII of the Social Security Act, less administrative expenses. This action was in accord with the popular belief that the intent of the Social Security Act is that the revenues produced by Title VIII should be used to finance the costs of old age benefits. There is nothing in the Act itself to this effect, and the Congressional committees which framed the Act insisted in their reports that this was not the intent of Congress. Nevertheless, in view of the appropriation actually made for the first year and the statements of many proponents of the law, it may not be amiss to discuss the financing of old age benefits as if the Act provided that the proceeds of the taxes levied in Title VIII, less costs of collection, are to be appropriated each year to the old age reserve account.

Making this assumption, it is necessary to understand the actuarial basis of the benefits provided in Title II.[2] These

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[2] For a more detailed explanation of the actuarial computations upon which the provisions in the Social Security Act relating to old age benefits were based, see the article by Otto C. Richter, "Actuarial Basis of Cost Estimates of Federal Old Age Insurance," in *Law and Contemporary Problems*, Vol. III, No. 2, pp. 212–220 (April, 1936).

benefits are retirement allowances at age sixty-five, which will range from $10 to $85 per month, and payments of 3½ per cent of the wages earned subsequent to December 31, 1936, to the estates of included wage-earners who die prior to the time when they have drawn retirement allowances of such a total amount and to persons who have total earnings of less than $2,000 or who are employed less than five years subsequent to this date. These benefits, taken together, were estimated by the actuaries, to cost an amount which can be paid for by taxes of 5 per cent per year on the earnings throughout the forty-five years of a normal industrial lifetime. This 5 per cent cost estimate assumes financing on a full reserve basis and interest earnings of 3 per cent compounded annually. It also assumes an average wage of $1,100 per year of all included wage-earners, unemployment averaging one-ninth of full time, and a continuance of present life expectancy. The benefits payable to workmen earning above $1,100 cost somewhat less than 5 per cent of the wages earned in 45 years, but this is the cost on the basis of present average wages as estimated by the actuaries.

Title VIII does not provide for taxes of 5 per cent on payrolls throughout the entire period during which the people to whom benefits will be paid under Title II are employed. The tax rates are 1 per cent on employees and 1 per cent on employers during the first three years, with an increase of ½ per cent each three years thereafter, until the maximum rate of 3 per cent on employees and 3 per cent on employers comes into effect in 1949. Not until the year 1946 will the combined tax on employers and employees amount to 5 per cent—which is the figure which has to be collected each year throughout the entire period of employment in order to pay the actual cost of the benefits provided in Title II. Moreover, nearly all people who are brought under the Act at the outset will not be subject to taxa-

tion for forty-five years, as they are already past twenty years of age. The net effect of these provisions is that the great majority of all people who become subject to taxes under Title VIII prior to 1946 will receive larger benefits than will be paid for by their tax payments and those of their employers, including interest. Future employees who begin work thereafter can, in all but very exceptional cases, look forward to larger benefits then could be purchased from their own taxes with interest, but after 1949 one-third of the employers' contributions will be used to make up the deficits in the amounts collected as taxes in the early years of the system, as compared with the true costs of the benefits to the employees included at the outset. The plan for financing the Federal old age benefits, thus, is not one in which more money is raised in taxes in the early years than is necessary to meet the costs computed on an actuarial basis, but one in which considerably less than the true cost is met through taxes in the early years, to be met after 1949 by slightly higher taxes than would otherwise be necessary.

Future Increase in Disbursements

At this point note needs also to be taken of a well known characteristic of all retirement plans. This is that the disbursements for benefits inevitably increase for many years. The average life expectancy of a man who reaches age sixty-five is about twelve years; of a woman, fifteen years. In consequence, it will be considerably more than a decade before we will have a normal retirement load. Moreover, both the number and the percentage of the people over sixty-five years of age is at this time rapidly increasing. Within a generation the number of old people is certain to be doubled and the percentage will probably be very nearly twice as great as now.

All this means, that the disbursements for Federal old

age benefits will be small for many years to come, but will increase rapidly and will not reach their maximum until about 1980, when the young workers of today will be of retirement age. If only sufficient taxes are raised to meet the current disbursements, the Federal old age benefit plan can for some years be financed by taxes of less than one-half of 1 per cent on employers and employees combined. Under this method of financing, however, the tax rates will have to be increased every few years and will ultimately greatly exceed the maximum rates now levied in the Social Security Act. Before 1970 the disbursements will exceed the expected tax collections, at the combined rate of 6 per cent which will then be in effect. By 1980, the disbursements will be so large as to require total tax collections amounting to approximately 10 per cent of the payrolls of that year.

Most of the advocates of the so-called "pay-as-you-go" method of financing say that this 10 per cent cost should be met only in part from payroll taxes. They want to reduce the rate of the taxes levied in Title VIII and then when a deficit develops have this paid from additional income taxes then to be levied, or from other general Federal revenues. To me these statements seem to be begging the question. No one can say at this time how Congress in 1960, or thereabouts, will attempt to meet the deficit which is certain to arise if present tax rates are reduced. That will depend, not only on the disposition of the Congress of that time, but upon the conditions then existing.

When Germany, a few years ago, faced a similar situation under its "pay-as-you-go" plan of financing old age insurance, it could not levy additional general taxes and so had to resort to an increase in contributions and a reduction in benefits. The truth is that the so-called "pay-as-you-go" plan contemplates an unprovided-for deficit, which is certain to develop before the younger workers of today will reach retirement age. This prospect is not alarming for

workers who are now past middle age, who will pay only a small part of the cost of their old age benefits, but it cannot be regarded complacently by younger workers, who will contribute much more in taxes.

In contrast, the plan envisaged by the actuaries who made the calculations for the Congressional committees is one in which there never will be a deficit and which is financed in full by the taxes now imposed. This is not a full reserve plan. Were it such, taxes of 5 per cent would have to be collected from the outset, and in addition the Government would have to contribute from general revenues enough money to make up the excess payments to all workers who have less than forty-five years of employment ahead of them. What is contemplated is a partial reserve, the interest upon which will in 1980 equal the difference between the 6 per cent collected from payroll taxes and the amount which will be disbursed in old age benefits, equal to 10 per cent of payrolls. This is the much criticised forty-seven billion dollar reserve—which will not reach such a total until 1980, but thereafter is expected to remain at approximately that figure.

The critics of the Social Security Act make the point that taxes will have to be raised to pay the interest on this reserve. This is, of course, true; but whether such taxes will represent any additional burden depends upon whether the reserve has been used to create additional indebtedness or to retire outstanding debt. The theory underlying the tax rates now imposed in Title VIII is that excess collections will in the immediate future, while there is still a large federal deficit, reduce the amount which has to be borrowed from outsiders, and, after the budget is balanced, will be used to retire outstanding tax exempt bonds. If so used, there can be no question that the total burden for old age benefits and interest on debt in future years will be less than if only sufficient taxes are raised to pay the amounts

currently disbursed for old age benefits. Expressed crudely, but substantially accurately, the situation is that under the "pay-as-you-go" plan taxes equal to 10 per cent of payrolls will have to be levied in 1980 for old age benefit purposes, in addition to taxes of 4 per cent for interest on debts owed to outsiders. Under the plan contemplated in the Social Security Act, taxes of 4 per cent will have to be levied to pay the interest on the debt owed the old age reserve account, plus the 6 per cent payroll taxes under Title VIII of the Social Security Act—in other words, taxes totaling 10 per cent, in contrast with taxes totaling 14 per cent under the "pay-as-you-go" plan.

Possibility of a Deficit

Many uncertainties are involved in these calculations. The actuaries very frankly conceded that the assumptions underlying their calculations may be way off. These include the assumption that benefit and tax rates will remain unchanged for forty-four years, although no law of comparable importance ever enacted in this country has remained unchanged for any such time. Equally unlikely are the assumptions that present wage rates and present life expectancy will continue unchanged. No one can now forecast, with any degree of certainty, what reserves, if any, there will be in the year 1980.

Neither can any one say that under the plan incorporated in the Social Security Act a deficit will not ultimately develop. Should such a deficit develop, much the same situation will be presented as under the so-called "pay-as-you-go" plan. Whenever deficits occur, the people in control of public affairs at that time will have to decide what to do. If the general financial condition of the country is such that the deficits can be met from general revenues, it seems probable that they will be met from this source, but there can be no absolute guarantee that contributions will not have

to be increased or benefits reduced. But of this we can be very certain: the more nearly the taxes collected in the early years approach the true cost of the benefits—which is 5 per cent of payrolls—the less likelihood there is that future contribution rates will have to be increased or promised benefits reduced.

This matter of collecting currently as large a part of the true costs of old age benefits as possible seems to me to be of considerable importance. The so-called "pay-as-you-go" plan fails to do this. As applied to a retirement system, the "pay-as-you-go" method of financing is a complete misnomer. It is not a plan under which the true costs are paid currently, but one under which only the amounts actually disbursed are met currently—which in the early years are far less than the true costs. "Pay-as-you-go" is analogous in an old age insurance system to the annual assessment basis of meeting costs, which is still used as a method of financing life insurance by mutual benefit associations and burial societies and was formerly used, with disastrous results in financing retirement allowances in industrial pension plans. Experience has demonstrated that this basis of financing is unsound in any form of insurance in which the disbursements are certain greatly to increase. It is surprising that, after it has come to be recognized that such a method of financing will not do for the retirement plans of private employers, it should be seriously advocated in a national retirement system. Its only merit is that present tax burdens are kept at a minimum; its obvious disadvantage, that it is certain to result in an unprovided-for deficit, which will endanger the payment of promised benefits to present younger workers.

That a deficit may develop even under the plan incorporated under the Social Security Act, I have already acknowledged. I recognize that in the final analysis the soundness of a national old age insurance system depends

upon the good faith of the Government and on its ability to raise through taxes enough money, not only to meet the costs of old age benefits, but all governmental costs. The amount of money in the old age reserve account at any given time is far less important than the total budget, tax, and credit position of the Federal Government. The question of reserves, many years from now, has been given undue importance. Clearly it is far less significant than many problems connected with old age security which are much more immediate, among them the matter of finding an assured constitutional basis for an old age insurance system and the danger that this country may substitute for a contributory old age insurance system an impossible plan of paying pensions of a flat amount to all old people, to be financed from general taxes.

While recognizing that the soundness of the Federal old age benefit plan will depend far more upon the general budget, tax, and credit position of the Federal Government than upon the amount of money in the old age reserve account, I am strongly of the opinion that the tax rates in Title VIII of the Social Security Act should not be reduced at this time and am doubtful about any large increases in benefits. Either reductions in tax rates or large increases in benefits are unsound, at a time when we are not collecting from the special taxes levied in Title VIII enough money to pay anywhere near the true costs of the benefits provided in Title II and while the budget of the Federal Government is still unbalanced. In any discussion of the financing of old age benefits, it needs ever to be kept in mind, that the benefits provided for in Title II are estimated to cost, on the average, an amount which would be produced by taxes of 5 per cent on the present average payrolls over a period of forty-five years. Until the combined tax rate on employers and employees reaches 5 per cent—which will not be until 1946—it is very false to talk about collecting

more in taxes than the cost of the benefits. Similarly, it seems strange that the very people who have expressed so much concern about the unbalanced Federal budget should advocate reductions of taxes which will help to balance the budget. If reduction in the tax rates under Title VIII were accompanied by an increase in income taxes producing the same amount of revenue, I would not object to the change, but this is not a practical question at this time.

In this connection I will hazard a prediction. I do not believe that the attack upon the alleged reserve basis of the Federal old age benefit plan will result in a reduction in the taxes levied in Title VIII of the Social Security Act. What is likely to occur, however, is that the benefits will be very materially increased before the old age insurance system really gets under way. Reserves may be kept down, not only by reducing taxes, but by increasing benefits. I predict that Congress will do the latter in preference to the former.

In making this prediction I have in mind the results of the attack upon the contributory feature of the Federal old age benefit plan which occurred during the recent Presidential campaign. When the original draft of the Social Security Act was prepared by the Committee on Economic Security, William Green and the other labor members of the Advisory Council on Economic Security acknowledged that employees should contribute to the cost of old age benefits, and nobody in behalf of labor objected to the contributory feature until the Republican candidates, their advisors, and many employers professed such great concern about the employees' contributions. Now organized labor is opposed to the contributory feature, and employers may ere long be asked to pay the entire costs of the old age benefits.

The attack upon the alleged reserve basis of financing old age benefits was in the recent campaign combined with the

criticism of the contributory features of the plan. Several of the most determined critics of the alleged reserve basis also were the advisors of the Republican candidates in their attack upon the contributory features, which every one now recognizes to have been a sorry mistake. It is my belief that the continued attack upon the large reserve which may develop in distant future years will have precisely the same effect. Taxes will not be reduced, but benefits will be increased; and increased benefits mean larger taxes ere long.

My greatest concern in this matter is not that the final outcome is likely to be an increase in taxes. Like many others I would like to see the benefits increased which are payable during the early years of the plan. There is a great deal to be said for the earlier payment of retirement benefits and an increase in the benefits to wage-earners who are now near retirement age. Some changes in this direction are probably necessary to satisfy a public which has been misled by attacks upon the alleged illiberality of the Social Security Act. What worries me is that any large increase in benefits will result in an unprovided-for deficit before present younger workers reach retirement age. In our concern for people who are now near retirement age, we must not lose sight of the younger workers who will pay a much larger part of the cost of the old age benefits to which they can now look forward.

Conclusion

In conclusion, let me repeat that the concern which has been expressed about the unmanageable reserves in the Social Security Act has little, if any, foundation in fact. It is a smokescreen designed to disguise an attempt to reduce taxes and to throw upon future generations costs which ought to be met at the present time. The outcome of raising this false reserves issue, in my opinion, will be an increase in benefits, which is likely to result in larger payroll taxes

and may also compel reductions in promised benefits to present younger workers.

All countries in the world which have old age insurance systems other than Great Britain and Sweden are financing costs upon a plan which, like the Social Security Act, contemplates the collection of taxes in the early years considerably in excess of the current disbursements. Great Britain follows the contrary policy, but the old age benefits which it provides are much less than those contemplated in the Social Security Act; moreover, its plan provides for sharp increases in future years and its experience has already demonstrated that this increase in taxes will have to be much greater than was anticipated when the law was enacted[3]—and, by no means least important, Great Britain has balanced its entire budget, while the United States is still far from doing so. Sweden has recently also gone on the current disbursements basis of financing old age insurance but at the same time has increased contribution rates; moreover, the Swedish system pays much smaller benefits than are contemplated under our law. World experience supports the conclusion, which was reached by the Committee on Economic Security and the Congressional committees, that financing on a current disbursement basis is unsound in an old age insurance system, at least while the total budget is unbalanced and no provision is made for raising through other taxes the true costs of the promised old age benefits. When the budget is balanced and some better tax is substituted for the payroll taxes, a reduction in these taxes may be desirable, or, in preference thereto, benefits may be increased. But at present, decreases in taxes or large increases in benefits are likely to wreck completely the old age insurance system, which has now been launched in this country with general popular approval.

[3] Norman Wilson, *Expected Population Changes and Their Effects upon Social Services.* London, Institute of Public Administration (1935).

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